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No. 781

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United States Court of Appeals

FOR THE SECOND CIRCUIT

SELECT THEATRES CORPORATION,

Plaintiff-Appellant,

—v.—

JAMES W. JOHNSON, Collector of Internal Revenue,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF AND APPENDIX OF PLAINTIFF-APPELLANT

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INDEX TO BRIEF

PAGE

Statement of the Case 1

Manner in Which Questions Are Raised 1

Undisputed Facts Regarding Equity Invested Capital Issue as Found by the Court Below, Stipulated or Appearing in the Record 2

Questions Involved Which the Trial Court Was to Hear and Determine 19

The Errors Claimed 20

POINT I

Plaintiff, under the facts involved in this case, is entitled to use as its basis for computing equity invested capital upon which its excess profits credit is to be computed, the basis of its assets as they were in the hands of its transferor, Shubert Theatres Corporation, less adjustments for liabilities as set forth in Section 760, of the 1939 I. R. C., as amended 23

POINT II

The Court below was in error when it held there was no continuity of interest present 28

A. The Court Below Was in Error When It Said That the Proprietary Interest Could Not Have Been Vested in the Holders of the Receivers' Certificates Before the Transfer of the Assets 28

PAGE

B. Moreover, in Considering the Extent to Which There Must Be Continuity of Interest, Congress Clearly Indicated That It Was Sufficient if an Interest or Control of 50% or More Remained in the Same Persons or Any of Them 34

POINT III

A. The Facts Clearly Establish That (1) the Proprietary Interest Shifted From the Shubert Creditors to the Holders of the Receivers' Certificates Before the Sale and (2) That Plaintiff Became the Owner of the Receivers' Certificates Before the Sale 37

B. At the Time of Sale the Equity in the Assets Was Not More Than $400,000, Which Was Only Sufficient to Take Care of the Administration Expenses and the Receivers' Certificates. This Meant There Was No Interest Left in the General Unsecured Creditors. The Entire Proprietary Interest Was Vested in the Holders of the Receivers' Certificates Both Immediately Prior to and After the Transfer of the Property. Thus, a 100% Interest Remained in the Same Persons 43

C. In Any Event, There Was a Continuity of Interest Sufficient to Satisfy the Statute Because a 50% or More Interest in the Property Remained in Lee and J. J. Shubert Who Were Creditors Prior to the Sale 46

D. In Any Event, an Interest of 50% or More Remained in Lee Shubert Who Was a Creditor Prior to the Sale 47

PAGE

POINT IV

In any event, there was continuity of interest sufficient to satisfy the statute because 100% of the stock ownership of plaintiff was distributed to the holders of the receivers' certificates, and the creditors, debenture holders and stockholders of the old corporation. Therefore, an interest of 50% or more remained in the same persons or any of them. The Lee Shubert letter of May 31, 1933, constituted a plan of reorganization 48

POINT V

There was a plan of reorganization, in any event 53

POINT VI

The equity invested capital of plaintiff is not to be reduced because subsequent to the date of acquisition, it lost certain of the properties it had acquired at the receivers' sale 60

POINT VII

Plaintiff's alternate position. If plaintiff is not entitled to compute its credit using the basis of the assets as they were in the hands of plaintiff's predecessor, the Shubert Theatre Corporation, then plaintiff is nevertheless entitled to a larger equity invested capital than has been allowed by the government 62

Plaintiff should be permitted to include in equity invested capital as a contribution to capital or surplus the old stock, credits and debentures released for the issuance of its stock 62

PAGE

CONCLUSION

It is respectfully submitted that plaintiff is entitled to prevail upon this appeal in all respects; that the judgment below should be reversed and the complaint reinstated 64

APPENDIX i

CITATIONS:

Cases:

Adamston Flat Glass Co. (162 Fed. 2nd 875) 27, 36, 37
Alabama Asphaltic Limestone Co. v. Commissioner, 315 U. S. 179 .....23, 25, 27, 29, 34, 58, 63
Alcazar Hotel, Inc., 1 T. C. 872 (Dec. 13,099) App. Dism. CCA—6th 31
American Central Mfg. Corp., 8 T. C. M. 368, Docket No. 16821, Tax Court CCH Dec. 16,935 (M) 24

Balridge Oil Company, 26 B. T. A. 810, Reversed 69 F. (2) 432; and 85 F. (2d) 762 44
Barclay Park Corporation (C. C. A. 2nd Cir.), 90 Fed. (2d) 595 .....30, 31
Bondholders Committee, etc. v. Commissioner, 315 U. S. 189 .....26, 64
Jesse Lee Brown v. Heiner (D. C. W. D. Penn.), 15 A. F. T. R. 899 (1933 C. C. H. Par. 9416) 28
Bryant Heater Co. v. Commissioner, Docket #48618 Tax Court Memorandum Decision (1954–200) CCH Dec. 20,670 (M) 24

Case v. Los Angeles Lumber Co., 308 U. S. 106, 116 .. 30
Cleveland C. C. & St. Louis Railway Co. v. Backus, 154 U. S. 439 45

PAGE

Commissioner v. Bankers Farm Mortgage Co., 145 Fed. (2d) 772 36
Commissioner v. Gilmore's Estate, 130 F. (2) 791 26
Commissioner v. West Production Co., 121 F. (2d) 9. Cert. denied 314 U. S. 682 45
Connohio, Inc. v. Commissioner—Tax Court Memo Decision CCH Dec. 18,002 (M) 24, 29
Corrigan, Laura M., 3 TCM 1014; CCH Dec. 14,157 (M) 28
C. T. Investment Co. v. Commissioner (C. A. 8), 99 Fed. (2d) 582 .....53, 54, 57

DeBlois v. Commissioner, 36 F. (2d) 11 27

W. N. Fry, 5 T. C. 1058 .....27, 28, 58

Gregory v. Helvering, 293 U. S. 465 27
Gross v. Bush Terminal Co. (C. C. A. 2nd Cir.), 105 Fed. (2d) 930 .....30, 31

Hadley Falls Trust Co. v. United States, C. C. A. 1; 110 F. (2d) 887 44
Helvering v. New President Corp., 122 F. (2d) 92, 96-97 (41-2 U. S. T. C. P. 9,603) 64
Helvering v. Minnesota Tea Co., 296 U. S. 378 26
Helvering v. Southwest Consolidated Corporation, 315 U. S. 194 .....24, 26
Elsie W. Hill Estate, 10 T. C. 109 .....27, 28
Hoboken Land & Improvement Co., 46 B. T. A. 495; affirmed 138 F. (2d) 104 59
Huey & Philip Hardware Co., 40 B. T. A. 781 (A) 44-45

LeHigh Metals Co., 6 T. C. 313 36
LeTulle v. Scofield, 308 U. S. 415 26
John B. Lewis Estate, 176 F. (2) 646, CCA 1st 27, 28

PAGE

C. H. Mead Coal Co. v. Commissioner, CCA 4th, 72 F. (2d) 22 ..... 24, 27
Minneapolis Northfield & Southern Railway v. Kelm, et al., 225 F. (2) 909, CCA 8th, aff'g 117 Fed. Sup. 325 ..... 23, 27, 32, 57
Monarch Electric & Wire Co., C. C. A. 7th, 38 Fed. (2) 417 ..... 36, 47
Monarch Electric & Wire Co., C. C. A. 7th, 38 Fed. (2) 417 36
Montgomery Building Realty Co., 7 T. C. 417 (a) 24, 29, 32
Muskegon Motor Specialties, 45 B. T. A. 551, affirmed (C. C. A. 6th Cir.), 134 Fed. (2d) 904 Cert. den. 320 U. S. 741 ..... 32, 36

Northern Pacific R. Co. v. Boyd, 228 U. S. 482 ..... 29, 30

Palm Springs Holding v. Commissioner, 315 U. S. 185 ..... 23, 26, 27, 35, 51
Paul C. Pancake v. Commissioner, Tax Court Memo Decision, unofficial report C. C. H. Dec. 18,091 (M) .. 46
Pearsall v. U. S., 52 F. (2d) 1050, Supp. to 49 F. (2d) 661 45-46
Pennsylvania Cement Co. v. Bradley, 274 F. 1003 33
Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U. S. 462 ..... 26, 59

William H. Redfield, et al., 34 B. T. A. 967, 973 53
Roosevelt Hotel Co. v. Commissioner, 13 T. C. 399 (a) 24, 50

Standard Coal, Inc., 20 T. C. 208 (acquiesced) 29, 53, 57
Scofield v. San Antonio Transit Co. (CCA 5), 219 F. (2) 149, cert. den. 350 U. S. 823 26
Southland Ice Co. v. Commissioner, 5 T. C. 842(A) .. 24, 31

PAGE

Tex Manufacturing Co., 37 B. T. A. 984 reversed other grounds (C. C. A. 7th Cir.) 102 Fed. (2d) 325 32

Van Kannel Revolving Door Co. v. Commissioner, 36 F. (2d) 1022 (C. C. A. 2nd) affirming 11 B. T. A. 1209 44

Weil, W. H. v. Donnelly, 111 Fed. Sup. 390 45
Westfir Lumber Co. v. Commissioner, 7 T. C. 1014 ....24, 26

Statutes:

1939 Internal Revenue Code, as amended

Section 52 (a) 34

Section 113 (a) 62

Section 113 (a) (7) (A) .....iii, 25

Section 113 (a) (12) ii

Section 718 (a) (1) .....25, v

Section 718 (a) (2) .....62, v

Section 718 (a) (4) 60

Section 718 (a) (7) 60

Section 718 (b) 60

Section 718 (b) (5) 60

Section 718 (c) (5) 60

Section 760 .....v, 25

1932 Internal Revenue Act

Section 112 (i) .....ii, 25, 34

Section 113 (a) (7) .....iii, 25, 34, 35

PAGE

Other Authorities:

54 Corpus Juris 393 26

Ways and Means Committee Report No. 2895, 76th Cong. 3rd Sess. page 25 C. B. 1940-2, page 503 61

Mertens, Law of Federal Income Taxation

Vol. 3, Sec. 21.97 31-32

Vol. 10A, Sec. 59.15 (1948 ed.) 45

Vol. 7A, Sec. 42.112 Page 589 (1943 ed.) 61

Treasury Department Regulation 77 64

Treasury Department Regulation 112

Sec. 35.718.2 60

Treasury Department Regulation 118

Par. 39.52-5 33

Par. 39.23 (k) (3) 43

INDEX TO APPENDIX

PAGE

Index to Record on Appeal 1a

Docket Entries 7a

Opinion 9a

United States Court of Appeals

FOR THE SECOND CIRCUIT

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—v.—

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ON APPEAL FROM THE UNITED STATES DISTRICT COURT
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BRIEF OF PLAINTIFF-APPELLANT

Statement of the Case

This case was tried before a Judge without a Jury in the Court below. Prior to the trial a pre-trial order was made which provided that certain so called legal issues with reference to the Plaintiff's equity invested capital case be first heard and determined (Exhibit 1, R. 86-107).* The Court found for defendant, dismissed complaint and judgment was entered in favor of defendant. Plaintiff is aggrieved on this appeal on the ground that the Court below incorrectly determined the legal issues regarding the equity invested capital issue.

The Manner in Which the Questions Involved Are Raised.

The questions involved are raised by Appellant having filed a Notice of Appeal (R. 141) with respect to a judgment which was entered upon an opinion made by Mr. Justice

* Paragraph 7(1) A, B and C of the pre-trial order and Paragraph 7(1) D and 7(2). All other matters were to await the hearing and determination of the legal issues.

Alexander Bicks of the United States District Court, for the Southern District of New York (R. 111-139).

The Undisputed Facts Regarding the Equity Invested Capital Issue as Found by the Court Below, Stipulated or Appearing in the Record

The Shubert Theatre Corporation, hereinafter referred to as "Shubert," was organized in 1924 for the purpose of taking over the theatrical enterprise which had been conducted for approximately twenty-five years by Sam Shubert, Lee Shubert and J. J. Shubert. It was one of the principal producers of legitimate theatrical attractions in the United States and the largest operator of legitimate theatres. The business had been highly profitable and continued so through its fiscal year which ended June 30, 1929. A severe decline in the securities market in the last quarter of 1929 and the general business depression which followed had a marked adverse effect on Shubert as well as on the theatrical industry, generally.* For the fiscal year ended June 30, 1930 it sustained a net loss of $1,231,000.; for the succeeding fiscal year $1,672,000., and for the period of less than four months, from July 1, 1931 to October 20, 1931, of $1,187,000. This loss in this period of approximately twenty-eight months aggregated $4,090,000. Shubert then found itself unable to discharge its obligations as they matured with the result that on June 11, 1931, Shubert endeavored to effectuate a plan of readjustment with respect to its then outstanding debentures (Exhibit 2, R. 479-486). Although 75% of the debenture owners were willing to go along with the proposed plan of readjustment, it became apparent that the plan would have to be abandoned and it subsequently was.

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* A summary review of conditions generally in the legitimate theatre industry is given in Paragraph "7" of Receivers' Report #15—Exhibit 17.

On October 20, 1931, a general creditor filed against Shubert a Bill of Complaint in an equity receivership proceeding in the United States District Court, for the Southern District of New York. Shubert admitted all of the allegations of the Complaint and joined in the prayers for relief therein contained. The Irving Trust Company and Lee Shubert were appointed receivers.

At the date the receivership proceedings were instituted, Shubert's liabilities consisted of $6,360,000., 6% gold debentures due in 1942; $323,000. accumulated interest on said debentures; $1,158,000. notes and accounts payable; federal amusement taxes in the sum of $9,000., and $284,000. of deferred credits. There were mortgages on real estate totalling $10,749,000. and accrued interest thereon, real estate taxes, totalled $493,000. The capital stock of Shubert consisted of 218,160 shares without par value of which 210,360 were issued and outstanding and 7,800 were held in the treasury. Messrs. Lee and J. J. Shubert owned either directly or indirectly 71,680 shares of Shubert stock (34% of the total outstanding shares) $619,000. principal amount of 6% gold debentures, and $660,000. of other debt.

During the operation of the business by the receivers the liquid assets continued to dwindle. Thereupon, in order to provide funds for the payment of the expenses of administration and the continued operation of the business, the receivers presented a plan for the continuation of the business. This plan among other things called for the creation of a second issue of interest bearing certificates of indebtedness or so called receivers' certificates in a principal amount not in excess of $400,000. maturing not later than March 1, 1933 and to sell all or any part thereof up to $300,000. in principal amount.*

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* There was a first issue of receivers' certificates in the amount of $50,000. which was sold during the period October 28, 1931 to February 1, 1932. These certificates were retired with interest when the second issue was created and are not involved in this case.

The order creating the second issue of receivers' certificates provided that:

1. The certificates shall not impose any personal liability on the receivers otherwise than as receivers.

2. The certificates shall be secured by (a) a direct charge upon the receivership estate, (b) a lien upon all the assets in the possession of the receivers subject and subordinate to all valid liens on any part of the assets covered thereby existing at the date of the appointment of the receivers, but prior and superior to the 6% gold debentures and all other unsecured debts. (c) Such charge and lien were to rank equally with the charge and lien of all other obligations of the receivers incurred in the operation of the business except administration expenses which by operation of law may be entitled to priority thereto, (d) such charge or lien shall in so long as the receivers shall not be in default in the payment of said certificates when due, limit or restrict the right of the receivers to dispose of any assets then in their hands or which may thereafter come into their hands in the conduct of the business or to apply such assets or the proceeds thereof to the payment of expenses and indebtedness incurred by the receivers in the conduct of the business, (e) all the certificates at the election of the holders thereof shall become immediately due and payable upon any sale of the assets in satisfaction of any final decree and the determination of the receivership or in the event that the Old Corporation shall be adjudged bankrupt, (f) the receivers were authorized by the agreement with the holders of the certificates to extend the maturity date for a period not exceeding three months from March 1, 1933.

The entire issue of said receivers' certificates was sold to The Atel Co., Inc. (hereinafter referred to as "Atel"), between June 2, 1932 and October 7, 1932.

Atel had been organized in March, 1932. From May, 1932 and thereafter all the outstanding stock of Atel was owned by Dorsar Enterprises, Inc., a New York Corporation which in turn was owned one hundred per-cent by a copartnership of which Lee and J. J. Shubert were each 50% copartners.*

The $300,000. for the purchase of the receivers' certificates by Atel was advanced by the aforementioned copartnership to Dorsar which in turn advanced the $300,000. to Atel (Exhibit 1, par. 10). The receivers' certificates were issued specifically in connection with a plan for the continuation of the business.

The receivers' certificates and plan for the continuation of the business came about in the following manner:

On March 11, 1932, the receivers held a meeting with various committees representing creditors and stockholders and presented them with a plan for continuation of the business. The proposed plan is set forth in paragraphs 23 to 36 inclusive of receivers' report No. 3. The meeting was adjourned to March 18, 1932 so that the committee members and their counsel might study the plan. It was pointed out to the various creditors that the receivers in a memorandum submitted to the creditors committee, showed:

> "a dividend of 4% or less to general creditors upon immediate liquidation on estimated total claims of eight million dollars, and the committees favoring the plan expressed the view that *continuation of the business, with a view to a possible reorganization* which

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* It was stipulated in the pre-trial order that all of the issued capital stock of The Atel Co. Inc., was at all times 100% controlled by a copartnership of which Lee Shubert and J. J. Shubert were the sole copartners. Further, it was likewise stipulated in the pre-trial order that all of the capital stock of Dorsar was at all times owned by the aforesaid copartnership and that Lee Shubert and J. J. Shubert were each 50% copartners thereof.

would preserve the value of the business as a growing concern, offered the only hope for any substantial recovery to creditors." (Italics ours.)

The protective committee for debentures, the creditors committee and the committee of stockholders, expressed themselves in favor of the proposed plan. The independent protective committee for debentures declined to express an opinion either for or against a continuation of the business under the proposed plan. The plan for continuation of the business provided for the authorization for the receivers to borrow the aforementioned three hundred thousand dollars on the aforementioned receivers' certificates (receivers' report #3, Pars. 23 to 36 inclusive, Exhibit #6).

The proposed plan for continuation of the business pointed out that the business of Shubert was one of the most uncertain and speculative of all businesses and it depended upon changing popular taste. Further, in connection with the plan that was offered, it was pointed out:

"from the very nature of the enterprise however, especially in the present general business condition, and because the plan involved the borrowing of a relatively large sum of money, *the proposal is hazardous and it may result in the holders of the receivers' certificates of indebtedness automatically coming into possession of all of the residue of the property, without the payment of any dividend to general creditors.* The Committees and other representatives of creditors who have expressed their approval of continuation of the business have been advised of these considerations." (Italics ours.)

Conditions went from bad to worse. Receivers' Report #11, Exhibit 1(5), filed January 4, 1933, gives a compre-

hensive review of all that the receivers did. The receivers reported that they had made drastic curtailment of expenses; had suspended all but one of their productions; had made every effort to realize as much capital as possible from the assets but in spite of this, operations had been unprofitable. On an accrual basis from the time of commencement of the receivership in October, 1931 to December 17, 1932, there was a loss of over $978,000. (Par. 16 of receivers' report 11, Exhibit 1(5)). There was an actual loss of $44,000. on a cash receipts and disbursement basis. Further, as part of the plan for continuation of the business, the receivers were making no cash payments except those of vital importance. For example, real estate taxes, mortgage payments and interest were permitted to accumulate and increase (Par. 31, receivers' report #1, Exhibit 4, Par. 33 receivers' report #3, Exhibit 6). Things were so bad that in their report #11, the receivers stated that it was no longer desirable for them to continue the business and recommended that the assets be sold and the proceeds thereof distributed to those entitled thereto. Petition requesting sale was presented to the Court (Exhibit 1(6)). Hearings with relation to this matter were held on January 4th, January 9th, January 16th and January 20, 1933 (Exhibit 25). A decree directing the sale was made on January 21, 1933 (Exhibit 1(7)). At these hearings prior to the entry of the decree directing sale, there were discussions concerning the fact that the parties hoped to work out a reorganization. Late in 1932 a reorganization committee had been formed consisting of representatives of the various creditors and stockholders committees as well as others (Par. 3(16) of Exhibit 1). A skeleton plan of the organization was worked out by the committee but subsequently abandoned (Par. 3(17) of Exhibit 1). However, at the hearing on January 9, 1933 in open Court, William Klein, who was Mr. Lee Shubert's personal attorney as well as attorney for Shubert, said:

"It is Mr. Shubert's desire that a plan of reorganization shall be worked out which will permit the creditors of Shubert Theatre Corporation to participate in such successor company. Efforts have been made in connection with certain groups of the creditors, to work out a satisfactory reorganization plan. So far, such plan has not been successfully worked out. *If, in collaboration with the several committees, it is impossible to work out such a plan, it is Mr. Shubert's intention to propose a plan on his own account and, if it is in any way possible to do so, to admit all of the creditors of the estate to some kind of participation in a reorganization company*" (pp. 10 and 11, typewritten minutes of hearing of January 9, 1933). (Italics ours.)

The decree directing sale provided that the assets should be sold either in bulk or in separate parcels to the highest bidder or bidders. In case of a bulk sale, an upset price of $400,000. was fixed. Any creditor or any stockholder or officer of the Shubert was given the right to purchase the assets in his own right and likewise Lee Shubert, one of the receivers, was permitted to bid at such sale or be interested in any corporation that might bid and he and any corporation might purchase the assets in their own right provided Lee Shubert resigned as a receiver prior to the sale. The decree further provided that

"no sale of the * * * assets * * * shall be confirmed to any purchaser on behalf of, or for the benefit of, any corporation organized or to be organized with the intention that it shall become the owner of said * * * assets * * * pursuant to any plan or agreement of reorganization unless at or before the sale * * * such purchaser shall have filed with the Special Master a complete copy of such plan or arrangement

> * * * and no sale of any property * * * to any purchaser who is to purchase such property pursuant to any such plan or agreement shall be confirmed if the Court shall determine that the provisions of such plan * * * are inequitable * * * So much of the purchase price as may not be required by the Court to be paid in cash may be paid in whole or in part by delivery to the Special Master, * * * outstanding Receivers' Certificates of Indebtedness and/or claims allowed * * * including claims in respect of the 6% Gold Debentures * * * The purchaser shall be credited on account of the purchase price with such sum * * * as would be payable in cash, out of the proceeds of the sale, in respect of said Receivers' Certificates of Indebtedness, Debentures, * * * and other claims, if the whole amount of the purchase price were paid in cash."

A proposed plan of reorganization was worked out by the reorganization committee under date of February 15, 1933. (Exhibit 3, R. 487-500) and under this plan the holders of the Receivers' Certificates were given preferred recognition. In the introductory statement to the proposed reorganization committee's plan of February 15, 1933, it was stated:

> "* * * it is questionable whether the properties and assets in the possession of the receivers can be sold for more than enough to satisfy the obligations of the receivers; it is probable that unless the following or a similar plan is consummated, the creditors may realize nothing whatsoever on the obligations held by them."

In March, Lee Shubert removed any disqualification to become a bidder at the sale or to be interested in the purchaser, by resigning as a receiver. In his application to

resign (Exhibit 1(8) R. 333-337) Mr. Shubert made the following statement:

> "Now that the property of said Shubert Theatre Corporation and the other corporations defendants herein have been decreed to be sold, it would seem probable that the main purpose of the receivership has been accomplished. It is further apparent that by virtue of your petitioner's investments in the Shubert Theatre Corporation and the other defendants corporations *the petitioner is vitally interested and desires to participate in the purchase of the assets of said defendants at said sale and in the reorganization of the defendant and in the reorganization of the properties so to be sold.*" (Italics ours.)

The sale which had originally been scheduled for February 24, 1933 was adjourned to March 17, 1933. The parties realized that it was possible that the plan of reorganization as proposed by the reorganization committee might not be consummated. For various reasons it was imperative that the proposed sale be adjourned to at least April 7, 1933. It was important that if there should be a sale, Mr. Shubert should be in a position to cause the properties to be bought in. Conditions were desperate* and in order to get the adjournment to April 7, 1933, Mr. Lee Shubert agreed to bid at the time of sale under the terms of the Court's decree of sale, not less than $400,000. for the properties and assets held in the receivership estate and to pay all the receivers' obligations on the sale and certain minimum fees to the receiver and its attorneys (Exhibit 1, Par. 20).

On April 5, 1933, the Select Theatres Corporation, Plaintiff in this action, was incorporated under the laws of the State of New York for the purpose of buying in the

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* This was around the time of the bank holiday.

assets of the Shubert Theatre Corporation (pre-trial order, Par. 3(22)).* On this very day at four o'clock in the afternoon, the reorganization committee consisting of representatives of the various creditors and stockholders' committees and others, met and caused the proposed plan of reorganization of February 15, 1933 to be abandoned for the reason that it could not be carried into effect because of the small amount of deposits of debentures and claims thereunder and insufficiency of the subscriptions of the preferred and common stock thereunder (Exhibit 1(10), R. 338-339). The sale was held before a Special Master on April 7th. The sale was advertised extensively. At the time of sale the properties were first offered separately but there were no bids made for any of the separate properties offered. Then the properties were offered in groups but there were no bids. Finally, all the assets were offered in bulk. The only bid made for all the property was in the sum of $400,000. and was made by the Select Theatres Corporation, the Plaintiff herein. The bid of the Plaintiff was dated April 7, 1933, and was in writing (Exhibit 1(13), Exhibit 1(16), R. pp. 357-359).

Upon the Special Master's report of sale and petition of the Plaintiff herein, a decree was entered confirming the sale. In the petition requesting confirmation of the sale (Exhibit 1(18), R. 386-389), Plaintiff recited that it intended to deliver the Receivers' Certificates to the Special Master on account of the purchase price and pray that the Special Master be directed to credit on account of the purchase price, such sums as would be payable out of the proceeds of sale in respect of said receivers' certificates as if the whole amount of the purchase price were paid in cash. The confirmatory decree authorized the Special

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* It should be noted from various exhibits that the attorneys for the reorganization committee were the attorneys for Select Theatres Corporation.

Master to accept said certificates as *pro tanto* payment of the purchase price (Exhibit 1(19), R. 390-396), and it further recited:

> "it appearing to the Court that said Select Theatres Corporation has not been organized with the intention that it shall become the owner of the properties and assets of defendants or any part thereof, or any beneficial interest therein, pursuant to any plan or agreement of reorganization and does not propose to purchase said properties and assets, or any part thereof, on behalf of, or for the benefit of, any other corportation organized or to be organized with such intention."

The Select Theatres Corporation at the time of its organization, two days before the sale, had an original authorized capital of 200 shares of common stock without par value. At its first meeting of the Board of Directors of said corporation which was held on April 5, 1933 it accepted an offer by The Atel Co. Inc., to purchase 101 shares of Plaintiff common stock for $404,000. to be paid $300,000. by delivery of the receivers' certificates and the balance, less accrued interest on said certificates, in cash (R. 348-356).

On April 17, 1933 the subscription agreement between Atel and Plaintiff was modified. Under the amended subscription agreement Atel subscribed to 140 shares for $14,000. and agreed to loan the company $390,000. (in cash and the aforesaid receivers' certificates) against its one year note.

The purchase at the Special Master's sale was consummated on April 25, 1933. Payment of the purchase price was made by Plaintiff delivering the receivers' certificates duly endorsed, plus $90,009.52 in cash representing the difference between the principal amount of the receivers'

certificates plus accrued interest and the $400,000. purchase price. Said ninety thousand odd dollars of cash was obtained in the same manner as the cash originally employed to purchase the receivers' certificates, to-wit: the Shubert partnership advanced the money to Dorsar, which in turn advanced the funds to Atel, which in turn advanced the monies to Plaintiff. The cash proceeds of the sale were applied to the payment of expenses of administration by the estate in receivership after which no amount remained available for distribution among the creditors or stockholders of Shubert.

On April 25, 1933 at the consummation of the sale, the receiver of Shubert and of the other subsidiary corporations in the receivership proceeding, transferred to the Plaintiff herein and its wholly owned subsidiaries, all the properties and assets of Shubert and its subsidiaries (R. 487-500, Exhibit 3(37).)

Immediately prior to the sale, Shubert in receivership had the following administration expenses, receivers' certificates, outstanding debentures, unsecured creditors, and outstanding stock (Exhibit 1, Par. 3(40)):

Estimated Unpaid Receivership Administration Expenses	$ 90,000.00
Receivers' Certificates	300,000.00
and Accrued Interest Thereon	10,000.00
Debentures	6,360,000.00
Accrued Interest on Debentures	327,275.00
Allowed Unsecured Claims	1,182,400.00
	$8,289,675.00

Outstanding shares of capital stock of Shubert Theatre Corporation numbered 218,160, of which 7,800 were in the Treasury of the Corporation.

On May 31, 1933, Lee Shubert directed a communication to the debenture holders and creditors and other creditors and stockholders of the Old Corporation offering to give them stock in the Plaintiff's Select Theatres Corporation in exchange for their surrender to the Old Corporation of their securities and claims for cancellation. (Pre-trial order, Exhibit 1(41).) A copy of the letter reads as follows:

"When the Court decided that the assets of the Corporation were to be sold at public auction, we offered the security holders a plan of reorganization, but the subscriptions were insufficient to carry it through. Consequently, the assets were purchased by Select Theatres Corporation (in which I have a substantial interest) for the upset price fixed by the Court—$400,000. No other bidder appeared at the sale. The sale was confirmed by the Court, and the transfer of the assets has been substantially completed.

"Select Theatres Corporation will be recapitalized with an authorized capital to consist of $400,000 of 6% noncumulative preferred stock, which may be issued up to the full amount of the price paid for the properties ($400,000), and 200,000 shares of common stock, with a nominal par value, both classes of stock being entitled to one vote per share.

"The stockholders of Shubert Theatre Corporation will, of course, receive nothing as a result of the sale of the Corporation's assets. Debenture holders and other creditors are entitled to their pro rata share of the purchase price after payments of expenses and Receiver's obligations; but it now appears likely that very little, if anything will be available for distribu-

tion to debenture holders and other creditors when the receivership is finally wound up.

"Nevertheless, it is my earnest desire that those who invested their money in Shubert Theatre Corporation, under my management, shall have an opportunity to participate in the new company, and to benefit with the return of prosperity, if such time arrives. Accordingly, I have arranged for the issuance of 50% of the common stock of Select Theatres Corporation to security holders and creditors of Shubert Theatre Corporation, without cost to them.

"This stock, the greater portion of which would otherwise become part of my personal holdings, will be distributed on the following basis:

"10 shares of common stock of Select Theatres Corporation in respect of each $1,000 debenture (with June 15, 1931, and subsequent coupons attached) of Shubert Theatre Corporation;

"1 share of common stock of Select Theatres Corporation in respect of each $105 of allowed claims against Shubert Theatre Corporation;

"1 share of common stock of Select Theatres Corporation in respect of each 10 shares of common stock of Shubert Theatre Corporation.

* * * * *

"Security holders and creditors of Shubert Theatre Corporation availing themselves of this offer should forward their securities or allowed claims to me in care * * * I will not take title to the securities and claims so forwarded but, acting as agent for the holders thereof, will surrender them to Shubert Theatre Corporation for cancellation. No transfer stamps or other expenses will be payable by those

who take advantage of this offer. The debentures and allowed claims will not be cancelled until it is definitely known whether or not there will be anything available for distribution to the holders thereof. If anything should be available, I will collect the amount due upon the debentures and allowed claims surrendered by those who have accepted my offer, and will turn over to them the amounts which they are respectively entitled to, less expenses incurred by me in that connection."

To permit the issuance of the stock in accordance with said letter Plaintiff caused its authorized capitalization to be modified to consist of 40,000 shares of 6% non-cumulative preferred stock, par value $10.00 per share, and 200,000 shares common stock, par value 10 cents per share. The 140 shares of common stock, no par value, previously authorized to be issued, were exchanged for 1400 shares of preferred stock. Atel's subscription agreement as previously amended was further modified. Instead of loaning plaintiff $390,000. Atel subscribed to 36,650 shares of preferred stock and 200,000 shares of common stock and agreed to pay therefor $366,500 and $20,000 respectively. 100,000 shares of said common stock were set aside for distribution of the debenture holders, general creditors and stockholders of Shubert in accordance with the offer contained in Lee Shubert's letter.

Of the shares of common stock thus set aside an aggregate of 79,731 shares were ultimately distributed among the holders of $5,472,000 principal amount of the 6% debentures (over 86% of the total amount outstanding); the holders of $692,968.20 face amount of general claims (over 63% of the total claims allowed in the receivership); and the holders of 175,361 shares of the capital stock of Shubert (over 82% of the number of shares outstanding),

in the amounts and proportions set out in the aforementioned letter. The remaining 20,629 shares of common stock were ultimately issued to Atel.

In order to obtain this distribution of common stock in the Plaintiff, the holders of the debentures, the creditors and stockholders of Shubert had to execute and deliver certain letters of transmittal and certain releases and had to surrender the debentures, claims and stock to Shubert in order to obtain the certificates of common stock in Select. (See Exhibits 1(26) through (32) inclusive, R. 433-445 inclusive.)

Plaintiff continued to operate with the assets taken over from the Shubert. As of the time of trial which was nearly twenty years later, a majority of the assets were still owned and operated by the Plaintiff (R. 42). There were some properties which were dropped, or lost by foreclosure during the period of time after Plaintiff took them over.

There is set forth in Exhibit 1(36) a list of the nine assets which Plaintiff took over from the Shubert at the Receivers' sale which were subsequently lost (R. 477-478).

Plaintiff was the same type of corporation as Shubert. It only did less volume of business (R. 42-43). It had the same management (R. 43-44). The offices of the corporation were kept in the same space (R. 44). The records are in the same place as they have been for the past thirty-five years (R. 45). An examination of the books and records of the old and new corporation showed that the records were continued in the same fashion as if there was no difference in corporate structure (R. 45-46).

During the course of the receivership, various parties and counsel interested in the reorganization and in the

receivership had before them and were aware of the *Boyd* case (228 U. S. 482), which later was referred to in the *Alabama Asphaltic Limestone Company* case (R. 5, R. 6) and the *Schiller, St. Louis, et al.* case (274 U. S. 304, R. 7, R. 8, R. 9).

Mr. Charles Fisk who worked on the receivership of the Shubert Theatre Corporation for the Irving Trust Company was called as a witness. He testified: That most of the theatres were not being operated because financial conditions were very bad and that one-half of the plays that were put on, failed (R. 18). That there were no buyers for the theatres. That he tried in some cases to approach the mortgagees who were not receiving interest on their principal and tried to get them to buy the equity which Shubert had, but the mortgagees would not take the properties back (R. 19). The mortgagees did not want to take the theatres back because they were not in a position to put any attraction in the theatre which Shubert could do. The theatres were worthless without attractions (R. 19, 21). No buyers appeared for the theatres (R. 22). This was the time of the bank holiday. There was no risk capital available. Any purchaser of the theatre would have had to pay tax arrears and interest and make alterations with the mortgagees as to principal. The matter regarding the theatres was fully reported in the theatrical papers, Variety and Billboard, as well as the general advertisement pursuant to the order of the Court (R. 23). There was no use for the theatres in the absence of the attractions. They were idle and there was nobody else who could do any better (R. 23). There was no demand for the theatres (R. 32), and nobody was interested in buying the theatres (R. 32).

Questions Involved

Questions Which the Trial Court Was to First Hear and Determine

In the pre-trial order the parties had agreed and the Trial Court proceeded to hear and determine the following questions:

A. In determining the amount of equity invested capital to be used by Plaintiff for inclusion in invested capital for the purpose of determining the excess profits credit of Plaintiff under the invested capital method for each of the fiscal years ended June 30, 1941, 1942 and 1943, did a reorganization occur for tax purposes whereunder reference is to be made to the basis in the hands of the transferor of the assets taken over by Plaintiff upon the receivers' sale in the Shubert Theatre Corporation, et al., receivership proceedings. If so, was the reorganization "tax free."

B. In the event that the Court shall determine that the basis in the hands of the transferor of the assets taken over by the Plaintiff upon the sale in the Shubert Theatre Corporation, et al., receivership proceedings, is not to be included in Plaintiff's equity invested capital for the purpose of determining its excess profits tax credit under the invested capital method for each of the fiscal years ended June 30, 1941, 1942 and 1943, then the Court shall determine whether Plaintiff is entitled to include in its equity invested capital the basis of the stock, unsecured claims and debentures of the former shareholders, creditors and debenture holders of the Shubert Theatre Corporation which they exchanged for the issuance to them of the stock of Plaintiff pursuant to the letter of May 31, 1933, addressed to them by Lee Shubert.

C. In the event that the Court shall not determine Questions "A" and "B" above in the affirmative, then is plaintiff entitled to include in its equity invested capital the fair market value of the assets which it purchased from the equity receivers, as the basis of the assets received on such sale.

It was stipulated that if the Court should determine either of the foregoing questions, "A," "B," or "C" in the affirmative, then the parties were to endeavor to stipulate and agree upon all adjustments to be made in the tax liabilities of the Plaintiff for the fiscal year ended June 30, 1943, or to have the Court determine same if they could not agree.

It was agreed between the parties that any proof regarding all matters other than those relevant to the issues set forth in sub-paragraphs "A," "B," and "C" above shall await the hearing and determination by the Court of the issues set forth in "A," "B," and "C" above.

The Errors Claimed.

1. The Court below erred in finding that there was no reorganization on the ground that there was no continuity of interest.

2. The Court below erred in finding that Plaintiff having acquired its property from Shubert through the media of the receivers' certificates could not have been deemed to have had a proprietary interest in the assets prior to the sale.

3. The Court below erred in failing to find that under all the facts the acquisition of the assets by the Plaintiff from the Shubert Theatre Corporation was a part of a plan of reorganization.

4. The Court erred in failing to find that the proprietary interest in the assets prior to the sale remained in the same persons subsequent to the sale.

5. The Court below erred in failing to find that a 50% or more interest or control in the assets remained in the same persons or any of them after the transfer of the property as before the transfer.

6. The Court erred in failing to find that the transfer of the assets from the Shubert to Plaintiff constituted a tax free reorganization.

7. The Court below erred in failing to find that under Section 113(a)(7)(A) or Section 113(a)(12) of the Revenue Act of 1939, as amended, applicable to the taxable years involved, the basis of the assets received by the Select Theatres Corporation from the Shubert Theatre Corporation as aforementioned in the hands of the Select Theatres Corporation was the same as they were in the hands of the Shubert.

8. The Court below erred in failing to find that for the purposes of computing its equity invested capital, Plaintiff is entitled to use a substituted basis and to compute the same pursuant to the provisions of Section 760 of the Internal Revenue Code of 1939, as amended.

9. The Court below erred in failing to find that the fact that Plaintiff subsequent to the time it received the assets from the Shubert, lost various of the assets by reason of foreclosure, giving of deeds in lieu of foreclosure, termination of leasehold interest and the like, of itself did not reduce Plaintiff's equity invested capital.

10. The Court below erred in failing to find that any deficit in earnings and losses in the operation of the business of the Plaintiff did not reduce the amount of equity invested capital below the amounts deemed paid in under Section 760.

11. Further, if it is determined that Plaintiff is not entitled to a substituted basis pursuant to Section 760, then the Court below erred in failing to find that Plaintiff had the right to include in its equity invested capital the basis of the stock, unsecured claims and debentures as they were in the hands of the former shareholders, creditors and debenture holders of the Shubert which they exchanged for the issuance to them of the stock of Plaintiff pursuant to the letter of May 31, 1933 addressed to them by Lee Shubert.

12. Further, if it is determined that Plaintiff is not permitted to compute its equity invested capital pursuant to the preceding paragraph or pursuant to Section 760, then the Court below erred in failing to find that Plaintiff is entitled to include in its equity invested capital the fair market value of the assets which it purchased from the equity receivers as the basis of the assets received on the sale.

POINT I

Plaintiff, under the facts involved in this case, is entitled to use as its basis for computing equity invested capital upon which its excess profits credit is to be computed, the basis of its assets as they were in the hands of its transferor, Shubert Theatres Corporation, less adjustments for liabilities as set forth in Section 760 of the 1939 I. R. C., as amended.

Minneapolis Northfield & Southern Railway v. *Kelm, et al.*, 225 F. (2) 909, CCA 8th, aff'g 117 F. S. 325;*

Alabama Asphaltic Limestone Co. v. *Commissioner*, 315 U. S. 179;*

Palm Springs Holding Corporation v. *Commissioner*, 315 U. S. 185;*

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* The *Minneapolis* case involved a transaction covered by the 1918 Revenue Act, the *Alabama* case the 1928 Revenue Act, and the *Palm Springs* case, the 1932 Revenue Act. The 1932 Revenue Act was in effect during the years 1932 and 1933. In the case at bar, the transfer of property took place in 1933. It was specifically held in the *Minneapolis* case that the definition of "reorganization" to be applied in cases such as this, is the one set forth in the Revenue Act for the year in which the transaction occurred.

In the *Alabama Asphaltic Limestone Co.* case the Supreme Court said, "The answer to the question turns on the meaning of that part of * * * the Revenue Act of 1928 which defined the term 'reorganization' because if there was a 'reorganization' the respondent was entitled to use the same basis of the old corporation provided in Section 113(a)(7)." The reorganization definition was the same in the 1932 Act as in the 1928 Act. As to this, the Supreme Court said in the *Palm Springs Holding Co.* case, the effect of Section 113(a)(7) of the Revenue Act of 1932 was discussed and again the Court held that if the requirements of the 50% rule of this section were met the section had to be given full effect and the transferee corporation was entitled to the basis of the transferor corporation (see footnote 1 of the *Palm Springs Holding Co.* case. Cited on page 35 of this brief).

In the *Adamston Flat Glass Co.* v. *Commissioner*, 162 F. (2) 875, the Court decided on the facts that a reorganization had taken place. It also decided that under the rule of the *Alabama Asphaltic Limestone Co.* case and the *Palm Springs Holding Co.* case, the new corporation could obtain the benefit of the basis of the Old Corporation if the 50% or more continuity of interest

Roosevelt Hotel Co. v. *Commissioner,* 13 T. C. 399(a);
American Central Mfg. Corp., 8 T. C. M. 368, Docket No. 16821, Tax Court CCH Dec. 16,935 (M);
Bryant Heater Co. v. *Commissioner,* Docket #48618 Tax Court Memorandum Decision (1954-20?) CCH Dec. 20,670(M);
Connohio, Inc. v. *Commissioner*—Tax Court Memo Decision CCH Dec. 18,002(M);
Montgomery Building Reaity Co., 7 T. C. 417(a);
Standard Coal, Inc., 20 T. C. 208 (acquiesced);
Southland Ice Co. v. *Commissioner,* 5 T. C. 842;
C. H. Mead Coal Co. v. *Commissioner,* CCA 4th, 72 F. (2d) 22;
Compare: *Helvering* v. *Southwest Consolidated Corporation,* 315 U. S. 194;
Compare: *Westfir Lumber Co.* v. *Commissioner,* 7 T. C. 1014.

A.

As a general proposition, it may be stated that: if (1) the Plaintiff acquired property after 1917 and before 1936; and (2) the property was acquired from a corporation in connection with a tax free reorganization; and (3) immediately after the transfer an interest or control in such property of 50% or more remained in the same persons, or any of them, then for equity invested capital purposes the basis of such property in the hands of Plaintiff (the transferee) shall be the same as it was in the hands of Shubert Theatre Corporation (the transferor), less ad-

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or control rule of Section 113(a)(7) could be established. The new corporation in the *Adamston* case was not successful because it was not demonstrated that it met the 50% continuity of interest or control rule.

justments for liabilities as set forth in Section 760.* IRC (*Section 760, Section 113(a)(7)(A)*). *Section 113(a)(12)* 1939 IRC, as amended, and *Section 113(a)(7)*, 1932 Revenue Act.

B.

Plaintiff acquired the property involved on April 25, 1933, which was after 1917 and before 1936. Therefore, the date of acquisition of the assets is not involved.

C.

It has been stipulated by the parties that all of the assets of the Shubert Theatre Corporation were transferred to the Plaintiff. Hence the question of whether substantially all of the property of one corporation was acquired by another is not involved in this case.**

D.

Section 112(i) of the Revenue Act of 1932 which was in effect in 1933 when the transfer took place, defined "reorganization" as including "the acquisition by one corporation of * * * substantially all the properties of another corporation." Notwithstanding the fact that Plaintiff acquired all the assets of the old corporation, and to that extent complies with Section 112(i) of the 1932 Revenue Act, Plaintiff recognizes that to have a reorganization, there is the necessity for the presence of "continuity of interest," which is developed in the cases of *Helvering* v. *Alabama Asphaltic Limestone Company*, 315 U. S. 179;

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* All references to Sections of the Internal Revenue Code refer to the 1939 Code as amended unless specifically otherwise noted.

** Plaintiff acquired all the property and assets of the Shubert Theatre Corporation. There were a certain few stock certificates it did not take because they were worth less than the cost of the transfer tax stamps, which would have had to be purchased to make the transfer. These certificates were destroyed by burning by order of the Court.

Palm Springs Holding Corporation v. *Commissioner,* 315 U. S. 185; *Bondholders Committee, etc.* v. *Commissioner,* 315 U. S. 189; *Helvering* v. *Southwest Consolidated Corporation,* 315 U. S. 194; *Pinellas Ice & Cold Storage Co.* v. *Commissioner,* 287 U. S. 462; *LeTulle* v. *Scofield,* 308 U. S. 415; *Commissioner* v. *Gilmore's Estate,* 130 F. (2) 791; *Helvering* v. *Minnesota Tea Co.,* 296 U. S. 378.

E.

The Supreme Court has said that just what facts would constitute a reorganization "embrace circumstances difficult to delimit" *Pinellas Ice & Cold Storage Co.* v. *Commissioner, supra.* Moreover,

> "The Courts do not purport to express any precise ironclad rule against which 'continuity of interest' can be measured in every case. Compositely the cases mean simply that the facts must be presented from which it can reasonably be concluded that the new corporation is in substance the old enterprise in a new form." *Scofield* v. *San Antonio Transit Co.,* (CCA 5) 219 F. (2) 149, *cert. den.* 350 U. S. 823.

The legal procedure employed is not material. *Palm Springs Holding Corporation* v. *Commissioner,* supra.

Prior to 1934 reorganizations customarily involved a sale. There was no section 77(b) of the Bankruptcy Act. There was no Chapter "10" Reorganizations. Reorganizations then were either voluntary or compulsorily effected by a receivership or foreclosure. *54 Corpus Juris 393;**

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* A reorganization as defined in Corpus Juris:

> "REORGANIZATION—A term employed with reference to corporations, and has been defined as meaning the reconstruction or rehabilitation of a corporation, especially a railroad, usually effected compulsorily by a receivership and foreclosure. The term in common

C. H. Mead Coal Co., 72 F. (2) 22; *DeBlois* v. *Commissioner*, 36 F. (2d) 11; *Alabama Asphaltic Limestone Co.* (315 U. S. 179); *Palm Springs Holding Co.* (315 U. S. 185); *Adamston Flat Glass Co.* (162 Fed. 2nd 875). Whether Court proceedings are employed is a "distinction without a difference." *DeBlois* v. *Commissioner, supra.*

F.

The facts are controlling in determining whether a reorganization actually took place and what the parties intended. *Alabama Asphaltic Limestone Co.* case, *supra; W. N. Fry*, 5 T. C. 1058; *Elsie W. Hill Estate*, 10 T. C. 138; *John B. Lewis Estate*, 176 F. (2) 646, CCA 1st; *Kelm, et al.* v. *Minneapolis Northfield & Southern Railway*, 225 Fed. 2d 909; *Gregory*, 293 U. S. 465. It is what actually happens that counts and not what the parties may label the transaction. Substance must take precedence over the form. The realities of the situation are not to be ignored.* All the facts must be viewed as a "whole."

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use denotes the carrying out, by proper agreements and legal proceedings, of a business plan for winding up the affairs of, or foreclosing a mortgage or mortgages upon the property of insolvent corporations. It is commonly applied to the formation of a new corporation by the creditors and shareholders of a corporation which is in financial difficulties, for the purpose of purchasing the company's works and other property, after the foreclosure of a mortgage or judicial sale." (54 Corpus Juris 393.)

* In the *John B. Lewis Estate* case, *supra*, the directors stated that they were adopting a plan of liquidation. Not one word was mentioned about a reorganization or a plan of reorganization. The Court made its determination on the "transaction viewed as a whole." It said, "In the light of the Bazley opinion and in that of Gregory, the important inquiry is not so much as the motives and purposes of the stockholders or the corporation, but as to the effect of what was done." Thus the Court said that, "on the record before us, we think it not open to a serious question that a genuine reorganization of a corporate business was accomplished by the transactions which took place in December, 1941, with a continuity of business enterprise and a continuity of interests in the same persons under a modified corporate structure. What was done was undertaken for reasons germane to the continuance of the

Corrigan, 3 TCM, CCH Dec. 14,157(M). "The mere mechanics of procedure should not blind us to realities." *W. N. Fry,* 5 T. C. 1058 citing *Walter S. Heller,* 2 T.C. 371 aff'd 147 Fed. 2nd 376, *cert. denied.*

POINT II

The Court below was in error when it held there was no continuity of interest present.

A.

The Court Below Was in Error When It Said That the Proprietary Interest Could Not Have Been Vested in the Holders of the Receivers' Certificates Before the Transfer of the Assets.

The real point involved, of course, in testing the question of continuity of interest is: who were the beneficial owners of the assets before the transfer, and did an interest remain in the same persons or any of them after the transfer. The Court below said that the "crucial" problem in the case at bar was "who are the old proprietors." However the Court below went on to say:

> "No case has been cited by counsel and independent research by the Court has failed to find one dealing with the status of a holder of receivers' certificates as a party to a reorganization. The dissimilarity between the origin and rights of the certificate holder and

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venture at hand." In the *Fry* case, *supra,* the Court said, "All parts of the transaction are to be considered together rather than separately, *Commissioner* v. *Alabama Asphaltic Limestone Co.,* 315 U. S. 179, and if there was in fact a "reorganization" of the old bank, its liquidation is merely one step in an intricate transaction." In the *Gregory* case, notwithstanding the fact that the taxpayer called the transaction a reorganization under the appropriate reorganization section of the 1928 Revenue Act, the Supreme Court held that a reorganization did not in fact take place. In the *Fry* case, the sale of the assets took place in 1933. The reorganization which was based upon a "hope," and the distributions took place as late as 1939. The *Elsie G. Hill Estate* case is to the same effect as the *John B. Lewis Estate* case.

those of the corporate creditor make apparent that the reasons for relating creditors to stockholders are absence in the case of the former."

In other words, because the holders of the receivers' certificates were not technically creditors of Shubert, they could not acquire a proprietary interest in the assets before the sale took place.

fore the sale took place. We believe that the entire viewpoint of the Court below was incorrect. It is not a question of classifying groups—be they creditors, stockholders, certificate holders, secured creditors, or unsecured creditors. It is a question of who were the beneficial owners of the equity in the assets immediately prior to the transfer and to what extent, if any, is this ownership represented in the same persons after the transfer. It is not how the parties relate one to the other. It is a question of how they relate to the assets. It is necessary that the full priority rule of the case of *Northern Pacific R. Co.* v. *Boyd,* 228 U. S. 482 be applied. *Alabama Asphaltic Limestone Co.* case *supra.* We do not see how the rule can be followed logically without coming to the conclusion that there can come a point of time when the lowering of the value of free assets causes the equity to remove itself from the unsecured creditors and vest in the owners of the receivers' certificates. Just as it would follow if the value of the assets continued to drop the equity would fall to first mortgage bondholders. *Connohio Inc.* v. *Commissioner, supra.* In *Montgomery Building Realty Co.,* 7 T. C. 417(a) the Court stated the priority rule as follows:

"True, the new stock was not issued here to all the old creditors but only to the holders of unsecured claims for advances to the old company. But, as the Court points out in the *Alabama Asphaltic* case, the full

priority rule of *Northern Pacific R. Co.* v. *Boyd,* 228 U. S. 482, applies equally to the bankruptcy and equity reorganizations. The upshot is that first mortgage bondholders having a prior lien on property sufficient to satisfy their claims are entitled to maintain that position and to be placed ahead of creditors holding unsecured claims or subordinate liens. See *Case* v. *Los Angeles Lumber Co.,* 308 U. S. 106, 116. Bondholders whose rights and priorities are left unchanged, even though some other interests undergo an alteration, are not even affected by a reorganization and ordinarily have no standing to contest it. 'A plan does not "affect" the claims of creditors when they retain exactly what they had before; the claims of the bondholders in the case at bar are of this * * * kind.'

Gross v. *Bush Terminal Co.* (C. C. A. 2nd Cir.), 105 Fed. (2d) 930. It is when such prior-lien creditors are asked to surrender a portion of their secured interests that a court will seek to compensate them by a share in the equity ownership. *In re Barclay Park Corporation* (C. C. A. 2nd Cir.), 90 Fed. (2d) 595.

The converse of the full priority rule of *Northern Pacific R. Co.* v. *Boyd* is that a junior interest for which there remains in fact some value cannot be excluded. Hence, if stockholders have a remaining equity, the plan should make some provision for them. By a similar process, it becomes necessary in evaluating a plan of reorganization to permit the most junior of the remaining interests to obtain a share of the equity ownership of the new reorganized enterprise, there being generally no lesser interest to which they can succeed.

Thus, when, in the present case, it became evident that the old stockholders retained no effective portion of

the remaining value of the old company, the junior creditors could be excluded only on the theory that the value of the assets was insufficient to satisfy the holders of prior liens. *In re Barclay Park Corp., supra.* Stated somewhat differently, if the first and second mortgage bondholders were sufficiently protected by the continuation of their lien and the assumption of their bonds, see *Gross* v. *Bush Terminal Co., supra,* the remaining value must have belonged to the general creditors who, under the *Alabama Asphaltic* rule thereupon became the equity owners. It is not necessary that there be a complete participation in the reorganized company by all the members of that class. For example, if the claims are assumed by the new corporation or even if those of a small minority are discharged in cash, both the continuity of interest and the 50 per cent interest or control requirements are satisfied. *Southland Ice Co.,* 5 T. C. 842 (Dec. 14,771). Added to this is the reasonable presumption that in any adversary transaction, the ultimate agreement will appropriately incorporate the true value of the contending interests. *Alcazar Hotel, Inc.,* 1 T. C. 872 (Dec. 13,099). We think it follows that the transfer of control to the junior creditors upon insolvency and the ownership by them of the equity in the new corporation subject to the assumption and continuation of the prior rights of the mortgage bondholders effectively carried through in the reorganization the ownership and control which had already become an economic reality, and that under the rule of the *Alabama Asphaltic* case the reorganization and basis provisions are applicable.

It may be that the further requirement of a 50 per cent interest or control 'in the same persons' is not identical with the concept of continuity of interest. See *Mertens*

Law of Federal Income Taxation, Vol. 3, Sec. 21.97. But, if not, it is difficult to see that the statutory requirement does not represent an *a fortiori* case. It permits only a 50 per cent interest without control and appears to require merely that some of the persons interested in the new corporation be the same, at least, where they represent a majority of the equity owners of the predecessor. See *Rex Manufacturing Co.,* 37 B. T. A. 984 (Dec. 10,051), reversed other grounds (C. C. A. 7th Cir.), 102 Fed. (2d) 325 (39-1 U. S. T. C. Par. 9328). In the present situation the virtual ownership and control of petitioner's predecessor by its general creditors and the issuance to them of all of petitioner's securities more than satisfies these conditions. *Muskegon Motor Specialties,* 45 B. T. A. 551, 559 (Dec. 12,144), affirmed (C. C. A., 6th Cir.) 134 Fed. (2d) 904 (43-1 U. S. T. C. Par. 9383)." *Montgomery Building Realty Co.,* 7 T. C. 417(a).

The Court below distinguishes the case at bar from the facts in the *Minneapolis Northfield and Southern Railway* v. *Kelm,* 117 F. S. 325 aff'd 225 Fed. (2d) 909 (8th Cir. 1955), because in the *Minneapolis* case the ultimate purchaser had purchased at a discount claims of creditors which were existing at the time the insolvency proceeding commenced, whereas the Receivers' Certificates in the case at bar did not exist at the time the insolvency proceedings commenced. We suggest that it is a distinction without a difference. The point of law is not who were the owners of the assets as a matter of form when the insolvency proceedings started. Rather the true test is, in substance, in whom was the proprietary interest resting immediately before the transfer of assets from one corporation to another. And was there a continuity of interest after the transfer.

Shubert, in equity receivership, was very much a going corporation up to and including the moment of sale. The creditors of the corporation could no more enforce their claims than the holders of the receivers' certificates while they were not in default.

There is nothing in the law which says that a person need be a creditor or stockholder in order to have continuity of interest.

If it is a fact that the value of the equity in the assets was so small that there was nothing left for the general unsecured creditors, then there could be no interest or control which remained in them. Hence, if the value of the equity was only sufficient to provide for the holders of the Receivers' Certificates, then the interest or control must have been in them prior to the sale.

The Receivers' Certificates were prior to and ranked ahead of the debentures and all unsecured debt of the corporation and were to rank equally with the charge or lien of all other obligations of the receivers incurred in the operation of the business and the administration of the estate. However, they came behind prior secured creditors. (Exhibit 1(4).) The realities of the situation fully demonstrate that the holders of the Receivers' Certificates were for all practical purposes like priority creditors. A receiver would be personally liable if it made a distribution except in order of priority of those entitled to the fund. *Pennsylvania Cement Co.* v. *Bradley,* 274 F. 1003. Insofar as the Treasury Department is concerned, the receivers for income tax purposes stand in the place of the officers and directors of the corporation.*

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* The Treasury Department Regulation 118, Par. 39, 52-5, in part says:

"If a receiver has full custody of and control over the business or property of a corporation, it shall be deemed to be operating such business or

Moreover, Section 52(a) of the 1939 Internal Revenue Code, as amended, required receivers who were operating the business of a corporation to make corporate returns for such corporations.

It is essential to examine the facts to find out for "practical purposes" when the proprietary interest in the assets shifted to the holders of the Receivers' Certificates. What was the time "they stepped into the shoes of the old stockholders." Did the sale only recognize "what had before been true in fact." *Alabama Asphaltic Limestone Co.* case, *supra.*

B.

Moreover, in Considering the Extent to Which There Must Be Continuity of Interest, Congress Clearly Indicated That It Was Sufficient if an Interest or Control of 50% or More Remained in the Same Persons or Any of Them.

Section 112(i) of the Revenue Act of 1932 which defines a reorganization should be read in conjunction with Section 113(a)(7) of the Revenue Act of 1932, which refers to the basis to be applied to assets taken over in a reorganization. This Section 113(a)(7) of the 1932 Revenue Act said that "if the property was acquired after December 31, 1917 by a corporation in connection with a reorganization, and immediately after the transfer *an interest or control in such property of 50% or more remained in the same persons or any of them,* then the basis shall be the same as

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property within the meaning of Section 52, whether he is engaged in carrying on the business for which the corporation was organized or only in marshalling, selling and disposing of its assets for purposes of liquidation. Notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee or assignee subject to the order of the court, such receiver, trustee or assignee stands in the place of the corporate officers and is required to perform all the duties and assume all the liabilities which would devolve upon the officers of the corporation were they in control."

it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss, recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made." Congress did not say that 100% of the owners before the sale had to be 100% of the owners after the sale. Congress was more liberal. It had said it was sufficient if only " * * * an interest or control in such property of 50% or more remained in the same persons or any of them." Congress did not say that anyone had to have title, or ownership or be a creditor, a stockholder or anything. Congress used the words "interest or control" which are much more liberal and of wider range. Thus, Congress opened the door to at least two standards.

One standard was "interest" which most likely meant proprietary interest based upon proprietary ownership. The other was "control" which probably meant either voting control or actual control. (*Palm Springs Holding Corp.* case, *supra.*)

In *Palm Springs Holding Corporation* v. *Commissioner, supra,* the Supreme Court quotes Section 113(a)(7) of the 1932 Revenue Act and then goes on to say:

> "That provision is applicable here. See Sec. 114(a), Sec. 113(b), Sec. 113(a)(12) of the Revenue Act of 1934, 48 Stat. 680. The property here involved was acquired after February 28, 1913, in a taxable year prior to January 1, 1934, as required by Sec. 113(a)(12). Respondent argues that this transaction was not a 'reorganization' within the meaning of Sec. 113(a)(7). And he points out that 'control' was not in the participating creditors since the majority of the new common stock had been distributed, for a consideration other than exchange of bonds, to Lacoe and Pinney. But he does not contend that assuming there was a

'reorganization' an 'interest' in the property of 50 per cent or more did not remain in the same persons (the bondholders) immediately after the transfer."

It is not necessary that who ever had a proprietary interest or control in the assets of the old corporation before the transfer have the same quantum of interest or control in the transferee. It is sufficient that the same persons, or any of them, who had a 50% or more interest or control in the old corporation collectively have a 50% interest or more interest or control in the new corporation. The percentage of interest or control which each person in the group may have may shift and change.

Muskegon Motors Specialties Co. v. *Commissioner,* 7 T. C. 417 (A. 1946-2 C. B. 4) July 30, 1930—C. C. A. 7th;

Commissioner v. *Bankers Farm Mortgage Co.,* 145 F. (2d) 722;

Adamston Flat Glass Co. v. *Commissioner,* 162 F. (2d) 875—June 5, 1947, Soper, *J.*;

Lehigh Metals Co., 6 T. C. 313;

Monarch Electric & Wire Co., C. C. A. 7th, 38 Fed. (2) 417.

"We agree with petitioners argument that the statute does not demand that the interest or control remain in identically the same persons, that is, in all of them; its terms are met if the statutory quantum of interest or control remains in any of them. *Muskegon Motor Specialties Co.* v. *Commissioner,* Cert. Denied 320 U. S. 741, 134 Fed. (2d) 904 (43-1 U. S. T. C. Par. 9382); *Commissioner* v. *Bankers Farm Mortgage Co.,* 145 Fed. (2d) 772 (44-2 U. S. T. C. Par. 9526)." (*Lehigh Metals Co., supra.*)

and further as was said in the *Adamston* case, *supra*:

> "If this underlying purpose of the statute is kept in mind, it will be seen that the continuity of the 50% interest in both the original owner and the transferee is essential and that the words 'or any of them' in the concluding portion of the section were used to give elasticity to the provision and make it unnecessary for persons holding or controlling a majority interest in the original owner to control precisely the same proportionate interests in the transferee."

POINT III

A.

The Facts Clearly Establish That (1) the Proprietary Interest Shifted From the Shubert Creditors to the Holders of the Receivers' Certificates Before the Sale and (2) That Plaintiff Became the Owner of the Receivers' Certificates Before the Sale.

The facts clearly demonstrate that during the course of the receivership the old corporation was losing substantial sums of money. The outlook was very bad. On March 11, 1932, the receivers held a meeting with various committees representing creditors and stockholders and presented them with a plan for the continuation of the business. In the receivers' memorandum to the various committees it was pointed out that the possibility existed for:

> "A dividend of 4% or less to general creditors upon immediate liquidation on estimated total claims of $8,000,000, and the committees offering the plan expressed the view that continuation of the business, with a view to a possible reorganization which would preserve the value of the business as a going concern, offered the only hope for any substantial recovery to creditors."

After studying the plan, the Protective Committee for Debentures, the Creditors' Committee and the Committee of Stockholders expressed themselves as in favor of the proposed plan. The Independent Protective Committee for Debentures declined to express an opinion either for or against a continuation of the business under the proposed plan. (Receivers' Report No. 3, Exh. No. 6, Par. 32.)

The plan for the continuation of the business provided for the authorization for the receivers to borrow $300,000 on receivers' certificates, which would be a first lien on the entire equity that existed in the assets of the old corporation. (Receivers' Report No. 3, Paragraphs 23 to 36 inclusive, Exh. No. 6.)

The proposed plan while pointing out that the business of the old corporation was one of the most uncertain and speculative of all businesses and that it depended upon changing popular taste, and that the plan offered the possibility of keeping the enterprise in existence and preserving its value as a going concern, went on to say that:

> "From the very nature of the enterprise, however, especially in the present general business conditions and because the plan involves the borrowing of a relatively large sum of money, the proposal is hazardous and *it may result in the holders of the receivers' certificates of indebtedness ultimately coming into possession of all of the residue of the property, without the payment of any dividend to general creditors.* The committees and other representatives of creditors who have expressed their approval of continuation of the business have been advised of these considerations." (Par. 35, Exh. No. 6.)

Thus, it is clear that the general creditors were willing to risk whatever equity they had in the assets and gamble

on that equity passing to the holders of the receivers' certificates. This plan in substance was approved by the Court order which followed, authorizing the issuance of the receivers' certificates. (Order of April 27, 1932, Exh. 1(4).)

4% of approximately $8,000,000 in claims comes to $320,000. That was the estimated equity which the general creditors had at the time that the plan of continuation of the business and for the authorization of the receivers' certificates was approved. In substance, they were willing to have the corporation mortgage the equity in the assets. They were willing to risk it. They saw no possibility of their salvaging anything substantial otherwise.

Conditions went from bad to worse. The Receivers' Report No. 11, Ex. 1(5), filed January 4, 1933, gives a comprehensive review of all that the receivers did. The receivers reported that they had made "drastic curtailment of expenses, have suspended all but one of their productions, and had made every effort to realize as much cash as possible from the assets," but in spite of all this "operations had been unprofitable." On an accrual basis from the time of the commencement of the receivership in October, 1931 to December 17, 1932, there was a loss of "$978,987 of which $299,134 represents losses on properties carried for account of mortgagees and lessors, and the balance of $679,853 represents loss on other properties." (Par. 16 of Receivers' Report No. 11, Exh. 1(5).) An actual cash operation on cash receipts and disbursements alone showed a loss in excess of $44,000 (Par. 17, same Exhibit). Moreover, as part of the plan for continuation of the business the receivers were making no cash payments except those that were of vital importance. Real estate taxes and mortgage payments were permitted to accumulate and increase.*

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* See Para. 31, Receivers' Report #1 (Exh. 4), and Para. 33, Receivers' Report #3 (Exh. 6).

Funded or postponed obligations were increasing. Heavy administration expenses were being incurred. The receivers could not see the slightest possibility of realizing enough cash income from continued operation of the business to pay either the receivers' certificates or other receivers' obligations before the end of the then current theatrical season and could not see the hope of being better able to do so by continuing the business. (Receivers' Report No. 11, Paragraphs 5 and 6, Exh. 1(5).) Thus the receivers concluded it was no longer desirable for them to continue the business and recommended that the assets be sold. Their petition requesting sale followed (Exhibit 1(6)). After hearings by the Court, the sale was authorized. The hearings were held on January 4, 1933, January 9, 1933, January 16, 1933 and January 20, 1933. The order directing the sale was entered January 24, 1933 (Exh. 1(7)).

Between October 20, 1931 to and including April 24, 1933, the day before the assets were actually transferred, the old corporation and its subsidiaries in receivership had an operating loss of $1,372,833.22 on an accrual basis (Receivers' Report #15, Para. 4, Exh. 17) and an excess of cash disbursements over cash receipts of $221,164.03 (Para. 16, Receivers' Report No. 15). In view of all this, it must be cogently clear and undisputed that sometime between the date that the receivers' certificates came into existence and the date of sale whatever equity or proprietary interest that the old corporation or the general unsecured creditors had in any of the assets must have shifted to the holders of the receivers' certificates.

These facts bear out unequivocally what was consummated so to speak at the moment of sale. The Court fixed a minimum price for the assets of $400,000. That was the bid at an open public sale. Surely the public sale is not questioned. The original sale was advertised once a week for

four successive weeks, prior to February 24. The first notice of adjournment was publicly announced at the time and place of sale on February 24, 1933, and then was published on March 1st, 8th and 15th, 1933. On March 17, 1933 again a public announcement of adjournment of sale was made, and then was published once a week for three successive weeks commencing on March 22, 1933. The sale was then held on April 7, 1933. (See Special Master Report presented April 12, 1933, Exh. No. 1(15).) In addition to the public advertisements of sale, there were people who had millions of dollars of investment in these assets. They were represented by numerous stockholders and creditors committees as will appear from the various hearings before Judge Caffey and the Special Master. From the time the application to sell the assets was first presented to the Court to the time of the public sale, the representatives were present. If there had been some possibility that they could have protected any equity that they had in the property, they would have done so. Yet, notwithstanding the fact that every asset was offered individually and then in groups and then in bulk, not one bidder other than the plaintiff came forward. The answer was that by the time of sale the assets were substantially worthless and nobody wanted them or could use them other than the Shuberts. The reason why this was so was cogently clear and is already well pointed out in the record. Whoever bought the assets had to carry the assets. The assets for the most part were heavily burdened with unpaid taxes, unpaid interest and principal on mortgages. There were no attractions to go into the theatres. They were dark, empty. There were no buyers.*

"7. At the commencement of the receivership, the properties of the Corporation constituted by far the

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* See testimony of Charles Fisk.

largest unit in the legitimate theatrical business in the United States, and its production activities were more extensive than those of any other producer. In the boom years, the legitimate theatre industry had been over-built. High rentals prevailed, born of keen competition in the acquisition and development of properties. Properties were mortgaged and taxed on a basis of values which now seems fantastic. These conditions were especially exaggerated in New York, but they prevailed also in the other principal cities. Nevertheless, up to 1929 speculative capital was poured lavishly into the business for the production of attractions; the theatres were kept open and, as a whole, their operations were seemingly profitable. The stock market decline of 1929 was followed by a decline in the number of productions and, as the depression grew worse, theatre attendance greatly decreased and fewer of the produced plays were financially successful. It seems probable that individually owned theatres fared materially worse than did the theatres owned by the important producers and the large theatrical organizations. Many of the independent theatres have been closed for two or three years. Others have been rented to attractions on terms which yielded much less than carrying costs. At any rate, the conditions were so bad that all were affected, and the effort of the Receivers to save something for the creditors of the Corporation was a hopeless task" (Receivers Report #15—Exh. 17).

Attempts to effect a reorganization pursuant to a plan in which all parties would participate between February 15, 1933 and April 5, 1933 failed. (Exhibit 3 and Exhibit 1(10).) Actually, under this plan of reorganization, it was to become effective when $500,000 of new capital was raised, Mr. Lee Shubert had undertaken to provide $200,000 of the

$500,000 new capital so that only $300,000 was needed. Yet old creditors and stockholders who had invested almost $14,000,000 could not raise $300,000 in new capital to protect their $14,000,000 investment.

These facts clearly demonstrate that the equity in the assets shifted from the general creditors to the holders of the Receivers' Certificates during the course of the receivership. The reasons given by the Court below to the contrary are untenable.

The record is also clear that prior to the time the assets were transferred from Shubert to plaintiff, plaintiff had become the owner of the receivers' certificates. It used the certificates as part payment of the purchase price.

B.

At the Time of Sale the Equity in the Assets Was Not More Than $400,000, Which Was Only Sufficient to Take Care of the Administration Expenses and the Receivers' Certificates. This Meant There Was No Interest Left in the General Unsecured Creditors. The Entire Proprietary Interest Was Vested in the Holders of the Receivers' Certificates Both Immediately Prior to and After the Transfer of the Property. Thus, a 100% Interest Remained in the Same Persons.

$400,000 clearly represents the maximum value of the assets as they existed at the time of sale, and conclusively demonstrates that the unsecured creditors of the old corporation had no proprietary interest whatever in the assets. Treasury Department Regulation 118, Par. 39.23 (k)(3)* says that:

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* This regulation has been on the books since 1926 without any substantial change.

Article 193 of Regulations 74, promulgated under the Revenue Act of 1928, is the same as Article 153 of Regulations 69, issued under the Revenue Act of 1926, which has continued to be found in the general Regulations issued under the successive Revenue Acts. See Art. 193, Reg. 77, under the Revenue

> "If mortgaged or pledged property is lawfully sold (whether to the creditor or to another purchaser) for less than the amount of the debt * * * *The fair market value of the property shall be presumed to be the amount for which it is bought in by the taxpayer in the absence of clear and convincing proof to the contrary."*

This regulation has been on the books for many years and is entitled to the force of law particularly because there have been reenactment of numerous statutory provisions without any change being required in this regulation. This gives legislative ratification of the regulation. *Hadley Falls Trust Co.* v. *United States,* C. C. A. 1; 110 F. (2d) 887.

The courts have likewise enforced this regulation and have repeatedly stated that in the absence of clear and convincing proof to the contrary the bid price at a duly advertised public sale must be taken as the fair market value of the property. *Van Kannel Revolving Door Co.* v. *Commissioner,* 36 F. (2d) 1022 (C. C. A. 2nd) 1467, affirming 11 B. T. A. 1209; *Balridge Oil Company,* 26 B. T A. 810. Reversed 69 F. (2d) 432 and 85 F. (2d) 762; *Huey*

Act of 1932; Art. 23(k)-(3), Reg. 86 (Revenue Act of 1934); Art. 23(k)-(3), Reg. 94 (1936); Art. 23(k)-(3), Reg. 101 (1928); Sec. 19.23(k)-(3), Reg. 103 (1939), under Int. Rev. Code, Sec. 23(k).

It is already familiar doctrine that a regulation interpreting a provision of the revenue laws is deemed, upon subsequent reenactment of the provision without substantial alteration, to have received legislative ratification and thereby to have been given the force and effect of law. *Helvering* v. *R. J. Reynolds Co.,* 306 U. S. 110, 115 (39-1 USTC, Par. 9282); *Helvering* v. *Winmill,* 305 U. S. 79, 83 (38-2 USTC, Par. 9550); *Mass. Mutual Life Insurance Co.* v. *United States,* 288 U. S. 269, 273 (1933) (3 USTC Par. 1045); *Lang* v. *Commissioner,* 304 U. S. 264 (1938) (38-1 USTC Par. 9308); *United States* v. *Dakota-Montana Oil Co.,* 288 U. S. 459, 466 (3 USTC Par. 1067); *Old Mission Portland Cement Co.* v. *Helvering,* 293 U. S. 289, 293-94 (35-1 USTC Par. 9009).

See also Regulation 111, Sec. 29.23(k)-3.

& Philip Hardware Co., 40 B. T. A. 781 (A); *Commissioner* v. *West Production Co.*, 121 F. (2d) 9. Cert. denied 314 U. S. 682; *H. W. Weil* v. *Donnelly*, 111 Fed. Sup. 390.

The Government in the case at bar has submitted no proof of any kind whatever to overcome the presumption of the sale price.*

Independent of the selling price of $400,000 for all of the assets, one of the most reliable guides to asset value is earning power (*Mertens Law of Federal Income Taxation*, Volume 10A, Section 59.15 (1948 Revised Edition)). The Treasury Department and Courts have frequently resorted to earnings as a highly reliable guide in the determination of value (*Mertens, id.*, Footnote 14, p. 27, Volume 10A) and, as was said by the United States Supreme Court in *Cleveland C. C. & St. Louis Railway Co.* v. *Backus*, 154 U. S. 439:

> "But the value of property results from the use to which it is put and varies with the profitableness of that use, present and prospective, actual and anticipated. There is no pecuniary value outside of that which results from such use."

Subsequent earnings due to unforeseeable circumstances, however, may not be used. *Pearsall* v. *U. S.*, 52 F. (2d)

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* At the time of trial, the Government sought to place some emphasis that there was some value in the real estate on the grounds that some of the real estate was free and clear and not subject to any mortgages. However, the fact that there were no bidders demonstrated there was no value. Secondly, the Government was incorrect when it contended as it did at the time of trial that some of the real estate was not subject to mortgages because an examination of Receivers Report No. 1, Exhibit 4, shows that in the few instances where mortgages do not appear on the properties, the properties were not owned by the Shubert Theatre Corporation or its subsidiaries, but rather, were leaseholds. For example, Schedule B attached to Receivers Report No. 1 shows no mortgages on the Barrymore Theatre, New York, the miscellaneous Philadelphia properties and the Princess Theatre, Chicago. On the other hand, however, said Schedule also shows that on these properties there were ground rents payable.

1050, Supp. to 49 F. (2d) 661; *Paul C. Pancake* v. *Commissioner,* Tax Court Memo Decision, unofficial report C. C. H. Dec. 18,091(M). Couple all this with the testimony of Charles Fisk. There just were no buyers for the theatres. Not even the mortgagees wanted them back. They were heavily burdened with real estate taxes and past due mortgage payments. There were no attractions for the theatres. We submit all the equity was in the holders of the Receivers' Certificates prior to the sale and after it, and that the test of continuity has been fully complied with.

C.

In Any Event, There Was a Continuity of Interest Sufficient to Satisfy the Statute Because a 50% or More Interest in the Property Remained in Lee and J. J. Shubert Who Were Creditors Prior to the Sale.

Lee and J. J. Shubert were creditors of the old corporation. They owned $619,000 principal amount of debentures and $660,000 of other debt. Their partnership owned all the stock of "Dorsar," which in turn owned all the stock of "Atel," which in turn owned all the Receivers' Certificates. The equity of the assets in the old corporation was really owned by the holders of the Receivers' Certificates, and if not 100% in them, then at least 50% or more. Whatever equity was not in the holders of the Receivers' Certificates must have been in the creditors. This was the situation before the transfer of the assets from the old corporation to the new corporation. The transfer took place. The new corporation acquired 100% of the assets. Upon such transfer there remained in "Atel" and Lee and J. J. Shubert collectively an interest of 50% or more. This complies with Section 113(a)(7). Thus, Lee and J. J. Shubert, creditors, in a grouping with "Atel" had an in-

terest of 50% or more before the transfer, and which remained in them or any of them when the transfer took place. Compare *Monarch Electric and Wire Co.* v. *Commissioner, supra.*

D.

In Any Event, an Interest of 50% or More Remained in Lee Shubert Who Was a Creditor Prior to the Sale.

We might also point out that before the sale took place Lee Shubert had agreed to bid $400,000 for the assets. The Court below said,* that because of this the holders of the Receivers' Certificate were assured of being paid off; hence the equity could not have been in them. If it were not in them, then it must have been in the Lee Shubert because he had agreed to bid that amount. In other words, beneficially he became the owner. Thus, since Lee Shubert had a 50% interest in plaintiff after the sale and had a 50% interest in the assets before the sale, there was at least one person a creditor, in whom an interest in the assets of 50% or more remained.

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* We do not agree with the Court's finding or holding on this connection but will assume its correctness solely for the purpose of arguing this point.

POINT IV

In any event, there was continuity of interest sufficient to satisfy the statute because 100% of the stock ownership of plaintiff was distributed to the holders of the receivers' certificates, and the creditors, debenture holders and stockholders of the old corporation. Therefore, an interest of 50% or more remained in the same persons or any of them. The Lee Shubert letter of May 31, 1933 constituted a plan of reorganization.

Lee Shubert through his attorney in open Court on January 9, 1933 said:

> *"It is Mr. Shubert's desire that a plan of reorganization shall be worked out which will permit the creditors of Shubert Theatre Corporation to participate in such successor company. Efforts have been made in connection with certain groups of the creditors, to work out a satisfactory reorganization plan. So far, such plan has not been successfully worked out. If, in collaboration with the several committees, it is impossible to work out such a plan, it is Mr. Shubert's intention to propose a plan on his own account and, if it is in any way possible to do so, to admit all of the creditors of the estate to some kind of participation in a reorganization company"* (pp. 10 and 11, typewritten minutes of hearing of January 9, 1933).

Also in his application to resign as Receiver (Exhibit 1(8) in March, 1933, Mr. Shubert said:

> "Now that the property of said Shubert Theatre Corporation and the other corporations defendants herein have been decreed to be sold, it would seem probable that the main purpose of the receivership has been accomplished. *It is further apparent that by virtue of*

your petitioner's investments in the Shubert Theatre Corporation and the other defendants corporations the petitioner is vitally interested and desires to participate in the purchase of the assets of said defendants at said sale and in the reorganization of the defendant and in the reorganization of the properties so to be sold."

On May 31st, 1933 Mr. Shubert wrote to the creditors the letter which offered to permit the old creditors and stockholders to share in the new corporation. Shortly prior to this the committee's plan to reorganize had been abandoned. Thus, Lee Shubert was carrying out the intention he had expressed in open Court on January 9th, 1933. Mr. Shubert proposed a plan in his own account " * * * to admit all of the creditors of the estate to some kind of participation in a reorganization company."

When the distribution of the stock of the new company was completed, the owners of the equity of the new corporation were made up solely of the following: (a) 100% of the holders of the receivers' certificates, 86% of the old outstanding debenture holders, 63% of the total other unsecured claims allowed in the receivership and the holders of 82% of the number of shares of stock of the old corporation.

The Court below said that the plaintiff does not and cannot urge that the gratuitous distribution of a portion of its voting securities to former creditors and stockholders of the old corporation was in pursuance of or constituted a plan or agreement of reorganization. The Court below is incorrect in this statement. Plaintiff does claim, has claimed and most strongly urges that the distribution was in accordance with a plan of reorganization. Mr. Shubert stated that if he could not work out a plan of reorganization in collaboration with the committee, he would propose one

on his own account. This he did. What was said in the *Palm Springs Holding Corporation* case is most appropriate.

> "Some contention is made, however, that this transaction did not meet the statutory standard because the properties acquired belong at that time to the committee and not the old corporation. That is true. Yet the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance to the complete affair. (*Gregory* v. *Helvering,* 293 U. S. 465; *Helvering* v. *Bashford,* 302 U. S. 454.) Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan."

The Court below points out that at the time plaintiff's bid was confirmed the court order said there was no plan of reorganization. This is true. The fact is the plan was made subsequently. Yet the intention to make a plan existed all the time.

In re: *Roosevelt Hotel Co., supra,* the Court said:

> "Respondent argues that no plan existed on May 1, 1931; that the intent of the committee at that time was to liquidate rather than to reorganize; that a plan, to qualify as a plan of reorganization, must provide for a continuation of the business, rather than liquidation; that the plan to form a new corporation was not made until four years after the trustee took control and, hence the petitioner did not acquire the property from Hotel Holding Company pursuant to a plan of

reorganization, but acquired it from the committee which had held it for four years without a plan."

As to this, the Court said:

"It is not material that at the time the trustee took possession of the property to protect the bondholders' interest there was no plan of reorganization, or that the committee considered other means of best realizing on the defaulted bonds. There is no statutory requirement that a plan be immediately adopted and to require this would disqualify as reorganizations many of the financial readjustments Congress intended to have included. It is inevitable that there be 'some delay in arriving at a solution satisfactory to the great majority of interested bondholders or creditors. In *Helvering* v. *Southwest Consolidated Corporation, supra,* the plan was not adopted until 18 months after the bondholders' committee took control, but the Supreme Court said that there would have been a reorganization, except for the requirement that the property be acquired solely for voting stock. The absence of a plan at the time the committee took control was not discussed. In the cited cases the Court expressed the view that the 'legal procedure employed by the creditors is not material' (*Palm Springs Holding Corporation, supra*), and the 'precise mechanics whereby the reorganization was consummated are not material' (*Bondholders' Committee, supra*). The form in which the transaction was finally cast is controlling, not what the interested lienholders may have considered as an alternative. The Bondholders' Committee here adopted a plan by 1935, pursuant to which it caused petitioner to be incorporated, purchased the property at the trustee's sale held under the trust indenture executed by the holding company to secure payment of the bonds,

> and had the trustee convey the property directly to petitioner. We conclude that petitioner acquired the property pursuant to a plan of reorganization."

Actually is there anything different which turned out here from what would have happened if all the interested parties went back to the Court in the original equity receivership proceedings and had an order entered in that proceeding. As a matter of fact, in order for the old creditors and debenture holders to get their new stock on the exchange it was necessary for them to surrender them to the old corporation. This all took place while the old equity receivership proceedings were pending. It was all referred to in the receivers report #15 (Exh. 1(17) Para. 10), filed March 7, 1934 and which was approved by order of the United States District Court on April 10, 1934 which said:

> "The report of the Receiver, designated Receivers' Report No. 15 and filed March 7th, 1934, is hereby approved * * * ."

Hence to the extent necessary (if any) it received the approval of the Court.

The Court places great emphasis on the letter which Mr. Waters, treasurer of plaintiff wrote on *March 27, 1936,* 3 years after the transfer took place to the effect there was no reorganization and that the distribution was gratuitous. As to this, we say it is at most one piece of evidence which carries little weight when compared to the "whole." It is what the transaction as a "whole" represented. Surely this piece of evidence is easily offset by the actual facts of what happened at the time it happened.

POINT V

There was a plan of reorganization, in any event.

The Government claims there was no plan of reorganization. Of course there was a plan of reorganization. It was implicit in everything that was done and by the conduct of the parties. A "plan" is a method or scheme of action, a way to propose to carry out a design. There is no need that it be in writing. It may take many forms. Thus, in *Standard Coal, Inc.* v. *Commissioner, supra,* it was said:

> "That there existed a 'plan,' contrary to respondent's first contention, appears to us manifest from the history of the situation. Webster's second definition of the word is a 'method or scheme of action, a way proposed to carry out a design * * * .' Webster's International Dictionary, Second Edition. What was proposed to the trustee, to the supervising court and to the bondholders was not only a foreclosure and sale but the expectation that the property would be bid in by a majority of the bondholders in the name of the new corporation whose stock would be issued in exchange for the bonds. The 'plan' was not required to be in writing, *William H. Redfield, et al.,* 34 B. T. A. 967, 973 (Dec. 9468), and the fact that the original program was changed to conform to the court's requirements no more prevented it from being a plan than if any other procedural impediment had required the first plan to be subsequently altered. See *C. T. Investment Co.* v. *Commissioner* (C. A. 8), 88 Fed. (2d) 582 (37-1 U. S. T. C. Par. 9151); *Jesse Lee Brown* v. *Heiner* (D. C. W. D. Penn.), 15 A. F. T. R. 899 (1933 C. C. H. Par. 9416)."

Also, in the case of *C. T. Investment Co.* v. *Commissioner* (C. A. 8), 88 Fed. (2d) 582, the Court, after review, said that a plan of reorganization need not take any particular form, that it need not be reduced to writing and that it might be amended as circumstances dictated:

> "The uncontradicted testimony of (the president of the company) read in connection with the option agreement set forth apparently at length in the opinion of the Board of Tax Appeals; and in connection with the stipulation of facts set out in the transcript, leave no doubt that what was done was done pursuant to a plan. Whether what was done amounted to a reorganization depends upon the provisions of the statute."

Let us look at the facts therefore to ascertain whether there was any plan to reorganize. The following occurred:

In June, 1931, Shubert endeavored to effectuate a plan of readjustment with respect to its then outstanding debentures (Exhibit 2). Although 75% of the debenture owners were willing to go along with the plan of adjustment, the financial condition of the corporation steadily grew worse so that by October 20, 1931 it became apparent that the proposed plan would be abandoned (See Paragraphs 16 and 17 in Exhibit 1(1)). On October 20, 1931, the equity receivership proceedings was started. From the prayer for relief in the bill of complaint and from the provisions of the order it will appear that the purpose of the receivership was to endeavor to preserve the assets as a going business and provide for continuity. Subsequently, the receivers' certificates were issued as part of a plan to endeavor to continue the business. This was followed by a reorganization committee being formed, made up of representatives of the debtor, the receiver and members

of the various creditor and stockholders committees. As conditions continued to get worse financially and it became necessary for the receivers to sell the assets, hearings were held before Judge Caffey; the first on January 4, 1933 and the next one on January 9, 1933. We respectfully call the Court's attention to a discussion concerning the proposed reorganization which the parties hoped to work out at that time. It was all very nebulous, but there was no question that Mr. Lee Shubert intended to work out a reorganization.

Mr. Shubert expressly said through his authorized attorney in open court that, if he could not work out a plan with the committees, it was his intention to propose a plan on his own account and, if there was some way possible to do so, it would provide for the creditors of the estate some kind of participation in the reorganization company (see quotation on page 48 of this brief).

After the order of sale was made a proposed plan of reorganization was gotten out by the committee, but as will appear from the minutes of the meeting of the reorganization committee held April 5, 1933 (Exhibit 1(10)), the proposed plan of reorganization of February 15, 1933 (Exhibit 3) was abandoned on April 5, 1933 because there were not enough subscribers. Previous to this Mr. Shubert resigned as a receiver. In his application to resign (Exhibit 1(8) Par. 3) Mr. Shubert said that he proposed to participate in the reorganization of the old corporation and of the assets to be sold (see quotation on pages 48 and 49 of this brief).

As will appear from the minutes before the Special Master, March 15, 1933 (Exhibit 25) the financial situation had continued to get worse and request was made by Mr. Lee Shubert to adjourn the sale from March 17, 1933 to April 7, 1933 and, as will appear from said minutes of the

hearing before the Special Master, Mr. Shubert agreed as consideration for that adjournment to carry the burdens of the receivership estate if conditions got worse, even to the extent of undertaking to provide sufficient funds to pay off all of the receivers certificates, the receivers obligations and the receivers administration expenses.

On April 5, 1933 plaintiff, Select Theatres Corporation, was organized under the laws of the State of New York for the purpose of buying in the assets of the Shubert Theatre Corporation (Pre Trial Order, Paragraph 3(22)). On the very same day, Atel, holder of all the receivers certificates, subscribed to all of the stock of Select Theatres Corporation, and the corporation authorized the bidding in of all of the assets at the sale and approved a proposed form of bid (Pre Trial Order, Paragraph 3(23), (24), (25)). A particularly pertinent portion of the minutes of the Board of Directors of the Select Theatres Corporation held on April 5, 1933 (Exhibit 12), reads as follows:

> "The Chairman stated that the properties and assets of Shubert Theatre Corporation and the other defendants in the above mentioned suit in the United States District Court for the Southern District of New York, were to be sold by the Special Master in that cause on Friday, April 7, 1933. He then read to the meeting Order No. 69 entered in that cause, being the decree of sale which describes the property to be sold and sets forth the terms and conditions of sale. He stated that it had been proposed that the Corporation bid at said sale for the acquisition of these properties and he presented to the meeting a proposed form of bid, which form was unanimously approved."

The sale took place, and the Select Theatres Corporation, as the then holder of all the receivers certificates, bought in all of the assets. There was a provision in the order

of sale which permitted the use of the receivers certificates to pay off any bid price. And when plaintiff moved for confirmation of the bid it stated it would apply the receivers certificates on account. For all intents and purposes the minutes of the meeting of the directors of the Select Theatres Corporation on April 5, 1933, together with the application to confirm constituted a plan to buy in these assets in behalf of the holders of the receivers certificates, and the holders of the receivers certificates at that time owned 100% of the proprietary interest in the assets that were to be bought. Thus, when the transfer of assets took place from the Shubert Theatre Corporation to the Select Theatres Corporation, there was a transfer by one corporation of substantially all of the assets of another corporation and there was complete continuity of the proprietary interest in the assets. Surely, the minutes of the meeting of the directors of Select Theatres Corporation on April 5, 1933 with or without the application to confirm was as effective as any of the writing as appeared in the *C. T. Investment Co.* case, the *Standard Coal, Inc.* case and the *Minneapolis Northfield & Southern Railway Co.* case referred to above, as to constitute a plan of reorganization.

But let us go one step further. On May 31st, 1933 Mr. Shubert sent the letter to the creditors and stockholders of the old corporation. This was certainly a plan of reorganization. Whether it was or was not a voluntary gratuitous act on the part of Mr. Shubert is not for us to gainsay. The fact is that the right to participate was a result of ownership of an interest in the old corporation. The fact that the new corporation was not formed in conjunction with any specific plan of reorganization is immaterial. That may have been true at that particular moment because there was no proposed plan of reorganization at that precise time, but whether there was a plan of reor-

ganization or not has nothing to do with the fact that under the statutory definition of Section 112(i) of the 1932 Revenue Act a reorganization took place because there was a transfer of substantially all of the assets of one corporation to another corporation with continuity of proprietary interest and there was a definite plan of conduct by the interested parties to effect a reorganization and a definite plan of reorganization actually came into existence.

The deeds of the parties speak loud. When all this is considered in conjunction with the statement made on January 9th, 1933 in open court by Mr. Shubert's counsel that Mr. Shubert, if he could not successfully work out a plan of reorganization with the committee, would work one out himself and, if it were possible give the creditors of the estate a participation in a reorganization company, then the following quotations from the case of *W. N. Fry*, 5 T. C. 1058, C. C. H. Dec. 14,836 have much meaning:

> "All parts of the transaction are to be considered together rather than separately, *Commissioner* v. *Alabama Asphaltic Limestone Co.*, 315 U. S. 179, and if there was in fact a 'reorganization' of the old bank, its liquidation is merely one step in an intricate transaction."

And again:

> "We do not believe the mere mechanics of procedure should blind us to the realities. Cf. Walter S. Heller, 2 T. C. 371; affirmed 147 F. (2d) 376, certiorari denied."

And again:

> "We think it is apparent from what appears in the minutes of the meeting of the stockholders and of the board of directors of the old bank, as above recited,

and there is nothing in material contradiction thereof, that distributions of the stock of the new bank made to the stockholders of the old bank in 1939 including that made to petitioner, were made as a part of and in pursuance of a plan of reorganization and in compliance therewith. In this connection it may be observed that there is no requirement that every detail of the plan, or even the plan itself, be reduced to writing. *Hoboken Land & Improvement Co.*, 46 B. T. A. 495; affirmed 138 F. (2d) 104."

In the *Fry* case, the sale of the assets took place in 1933. Moreover, the testimony in the case was by one of the officers to the effect that:

"At the time the new bank was being organized it was his hope and intention that the stock of the new bank should be distributed to the stockholders of the old bank in exchange for their stock in the old bank and that this was 'our hope throughout the entire reorganization.'"

It is not what the parties label the transaction. It is what it actually is that counts for income tax purposes. Reorganizations "embrace circumstances difficult to delimit." *Pinellas* case, *supra*.

The new corporation was a complete continuance of the old business, as was testified by Mr. Becker at the trial. It continued to occupy the same offices, it had the same top management, it continued to own and operate the assets that were taken over except for those which were subsequently lost, but the majority of which are still owned and operated by the corporation up to the present time. The new corporation operates the same business as was carried on by the old corporation.

POINT VI

The equity invested capital of plaintiff is not to be reduced because subsequent to the date of acquisition it lost certain of the properties it had acquired at the receivers' sale.

As will appear from the Stipulation of Facts,* between April 25, 1933 when plaintiff acquired certain of the assets from Shubert and the beginning of the first excess profits tax year in 1940, plaintiff lost various of the properties by reason of foreclosure, giving deeds in lieu of foreclosure, termination of leasehold interest and the like. These occurred in the operation of the business of the corporation. The mere fact that a corporation loses assets or has a deficit in its operation does not mean that its equity invested capital is to be reduced.

Sub-section (b) of Section 718 of the 1939 Internal Revenue Code, as amended, deals with reductions in equity invested capital. It does not list as an item giving rise to a reduction losses which occurred in the operation of the taxpayer's business. It will be noted that it does not list a deficit in operations as a basis for reduction. Section 718(a)(7), Section 718(b)(5) and Section 718(c)(5) deals with deficits in earnings and profits of another corporation. It does not deal with deficits occurring in the taxpayer's operation. While it is true that accumulations of earnings and profits at the beginning of a taxable year will increase equity invested capital (Compare Section 718(a)(4) and Regulation 112, Section 35.718.2) the same is not true about losses. Regulation 112, Section 35.718.2 states in part:

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* Exhibit 1(36) R. 477-478.

"If there is a deficit in the accumulated earnings and profits as of the beginning of the taxable year, such deficit shall not be taken into account in determining invested capital, and in such cases the earnings and profits as of the beginning of the taxable year shall be considered as zero, but subsequent earnings and profits shall be applied against such deficit."

Mertens Law of Federal Income Taxation, Volume 7A, Section 42.112, page 589 (1943 Edition) says:

"The regulations incorporate the language contained in the reports of the Congressional Committee to the effect that if there is a deficit in the accumulated earnings and profits as of the beginning of the taxable year, such deficit shall not be taken into account and in such cases the earnings and profits of the beginning of the taxable year shall be considered as zero."

In the Report of the Ways and Means Committee on hearings with respect to the commencement of the Excess Profits Tax Law, it was said:

"*Deficits in the earnings and profits account, moreover do not reduce the invested capital.* Nevertheless, deficits in the earnings and profits account must be made good out of earnings and profits before any increase in invested capital results from the earnings and profits account."

Ways and Means Committee Report No. 2895, 76th Cong. 3rd Sess. page 25 C. B. 1940-2, page 503.

POINT VII

Plaintiff's alternative position. If plaintiff is not entitled to compute its credit using the basis of the assets as they were in the hands of plaintiff's predecessor, the Shubert Theatre Corporation, then plaintiff is nevertheless entitled to a larger equity invested capital than has been allowed by the government.

Plaintiff should be permitted to include in equity invested capital as a contribution to capital or surplus the old stock, credits and debentures released for the issuance of its stock.

It is plaintiff's position that, if the Court should determine that the basis in the hands of the transferor of the assets taken over by plaintiff is not to be included in plaintiff's equity invested capital, then the Court shall determine whether plaintiff is entitled to include in its equity invested capital the basis of the stock, unsecured claims and debentures of the former shareholders, creditors and debenture holders of the Shubert Theatre Corporation which they exchanged for the issuance to them of the stock of plaintiff pursuant to the letter of May 31, 1933 addressed to them by Lee Shubert (Pre Trial Order, paragraph 7(1)(b)).

Section 718(a)(2) of the I. R. C. includes in equity invested capital property previously paid in regardless of the time paid in for stock or as paid in surplus or as a contribution to capital. Such property is to be included in an amount equal to its basis unadjusted for purpose of determining loss upon sale or exchange.

Section 113(a) of the I. R. C., which controls the unadjusted basis of property, said that:

"The basis of property shall be the cost of such property except that * * * (8) if the property was acquired after December 31, 1920 by a corporation * * * (b) as paid in surplus, or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made."

The record in this case, of course, clearly shows that while all of the capital stock of Select Theatres Corporation appeared to be subscribed by The Atel Co. Inc., Atel did not have all of this stock issue to itself. There was an additional consideration for most of the stock. The facts show that 79,731 shares of common stock of Select Theatres Corporation were issued in accordance with the offer set forth in Lee Shubert's letter dated May 31, 1933 in exchange for $5,472,000 face amount of debentures, $692,963 face amount of general unsecured claims and 175,361 shares of capital stock. If the moneys which were paid in by The Atel Co. Inc. for all of its stock represented consideration therefor, then whatever claims of any kind or nature which the old debenture holders, creditors and stockholders released and gave up must have represented a contribution to the capital and surplus of the Select Theatres Corporation. This must follow because either the old debenture holders, creditors and stockholders of the Shubert Theatre Corporation had no interest immediately after the sale or had an interest immediately after the sale. If they had no interest immediately after the sale, then, of course, the full proprietary interest must have been vested in The Atel Co. Inc. and a reorganization must have full taken place in accordance with the doctrine of the *Alabama Asphaltic Limestone Co.* case. If no reorganization took place and

the old debenture holders, stockholders and creditors had an interest, they must have surrendered that interest because their interest could only have been in the form of a claim against the assets which were taken over and which they gave up and released. Surely if the Government contends that prior to the sale the old creditors, debenture holders and stockholders had no interest in the assets of the old corporation which survived the sale, then that, of course, would completely establish without anything further that The Atel Co. Inc. must have been in 100% control both before as well as after the sale of the assets. But, if they had an interest which survived the sale, then a contribution was made to surplus or capital here. Whatever the basis was of the claims, stock and debentures in the hands of the holders thereof which were released in exchange for Select stock, should be included in the equity invested capital of Select Theatres Corporation.

CONCLUSION

It is respectfully submitted that plaintiff is entitled to prevail upon this appeal in all respects; that the judgment below should be reversed and the complaint reinstated.

Respectfully submitted,

VICTOR R. WOLDER
Attorney for Plaintiff-Appellant
347 Madison Avenue
New York 17, N. Y.

APPENDIX

Section 112(i) of the Revenue Act of 1932.

"The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, (C) a recapitalization, or (D) a mere change in identity, form or place of reorganization however effected."

Section 113(a)(7) of the Revenue Act of 1932.

"(7) Transfers to corporation where control remains in the same persons. If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer."

Section 113 (a)(7)(A) of the 1939 Internal Revenue Code, as amended.

"Sec. 113—Adjusted Basis for Determining Gain or Loss

(a) Basis (unadjusted) or Property. The basis of property shall be the cost of such property; except that

* * * * *

(7) Transfers to Corporation—If the property was acquired—

(A) After December 31, 1917, and in a taxable year beginning before January 1, 1936, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, or

* * * * *

(B) In a taxable year beginning after December 31, 1935, by a corporation in connection with a reorganization.

Then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer."

Section 113(a)(12) of the 1939 Internal Revenue Code, as amended.

"BASIS ESTABLISHED BY REVENUE ACT OF 1932—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932, 47 Stat. 199, was prescribed by section 113(a)(6)(7) or (9) of such Act, then for the purposes of this chapter the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932." IRC 113(a)(12).

Section 718(a) of the 1939 Internal Revenue Code, as amended.

"(1) MONEY PAID IN—Money previously paid in for stock, or as paid in surplus, or as a contribution to capital;

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(2) PROPERTY PAID IN—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115 (1) for determining earnings and profits;"

Section 760 of the 1939 Internal Revenue Code, as amended.

"Sec. 760 (Internal Revenue Code). (a) DEFINITIONS. For the purpose of this section—

(1) 'EXCHANGE,' 'TRANSFEROR,' and 'TRANSFEREE'—The term 'exchange' means a transaction by which one corporation (hereinafter called 'transferee') receives property of another corporation (hereinafter called 'transferor') and the basis of the property received, in the hands of the transferee, for the purposes of section 718 (a) is determined by reference to the basis in the hands of the transferor.

(2) 'DETERMINATION OF BASIS OF PROPERTY RECEIVED'—The basis, in the hands of the transferee, of the property of the transferor received by the transferee upon the exchange shall be determined in accordance with section 718 (a).

(b) RULE—In the application of section 718(a) to a transferee upon an exchange in determination of the amount paid in for stock of the transferee, or as paid-in surplus or as a contribution to capital of the transferee, in connection with such exchange, only an amount shall be deemed to have been so paid in equal to the excess of the basis in the hands of the transferee of the property of the transferor received by the transferee upon the exchange over the sum of

(1) The amount of any liability of the transferor assumed upon the exchange of any liability subject to which such property was so received, plus

(2) The amount of any liability of the transferee (not arising out of any liability described in paragraph (1) constituting consideration for the property so received, plus

(3) The aggregate of the amount of any money and the fair market value of any other property (other than such stock and other than property described in paragraph (1) and (2) transferred to the transferee.

(c) REDUCTION IN DAILY INVESTED CAPITAL—In the application of section 717 to a transferee upon an exchange, the daily invested capital for any day after such exchange shall be reduced by an amount equal to the amount by which the sum of the amounts specified in paragraphs (1), (2) and (3) of subsection (b) exceeds the basis in the hands of the transferee of the property of the transferor received upon the exchange."

APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Civ. 52-331

SELECT THEATRES CORPORATION,

Plaintiff-Appellant,

—VS.—

JAMES W. JOHNSON, Collector of Internal Revenue,

Defendant-Appellee.

INDEX TO RECORD ON APPEAL

	Pages of Original Record
Photostat copy of docket entries	A-B
Transcript of Record of Proceedings, dated 2/14/55	1-58(a)
Complaint	59-68
Summons and return	69-72
Stipulation and order extending time to answer	73
Stipulation and order extending time to answer	74
Stipulation and order extending time to answer	75
Answer	76-79
Affidavit of Adjournment	80
Affidavit of Adjournment	81

Index to Record on Appeal

	Pages of Original Record
Affidavit of Adjournment	82-83
Affidavit of Adjournment	84-85
Pretrial order, Sugarman, J.	86-107
Affidavit notice of motion for adjournment	108-110
Opinion #22,945 and judgment denying refund. Bicks, J. mailed notice of entry 10/1/56	111-139
Plaintiff's Stipulation	139(a)-139(b)
Defendant's Stipulation	139(c)-139(d)
Bill of Costs taxed at $20	140
Plaintiff's Notice of Appeal	141
	—2—
Appeal Bond	142-144

The following documents are exhibits in this case and are lodged in the custody of the clerk. Most of the exhibits constitute the original filed documents in the case of Gerson, Beesley and Hampton, Inc. compla ıant, vs. Shubert Theatre Corporation, defendant, Index #E62-296, District Court of the United States, Southern District of New York, and are to be returned to this Court for filing:

Exhibit

1 Pretrial order—Sugarman, J.
A stipulation of facts
(numbered pages 86-107 above)

Index to Record on Appeal

Exhibit		Pages of Original Record
1-(1)	Bill of complaint in Shubert Theatre et al equity receivership	145-165
1-(2)	Answer in said equity receivership	166-167
1-(3)	Order appointing receivers	168-174
1-(4)	Order authorizing said receivers to continue the business and to create an issue of receivers certificates	175-183
1-(5)	Receivers report #11	183(a)-183(m)
1-(6)	Receivers petition for leave to sell assets	184-281
1-(7)	Order decreeing and directing said sale	282-330
1-(9)	Order of Court granting petition of Lee Shubert to resign as receiver	331-332
1-(8)	Petition of Lee Shubert requesting permission to resign as a receiver	333-337
1-(10)	Minutes of meeting of reorganization committee declaring reorganization plan of Feb. 15, 1933 abandoned	338-339
1-(11)	Subscription agreement between The Atel Co. Inc. and Select Theatres Corporation	340-347
		—3—
1-(12)	Minutes of meeting of Directors of Select Theatres Corporation, dated 4/5/33	348-356
1-(13)	Form of bid (accepted)	357-359
1-(14)	Order amending order of sale	360-378
1-(15)	Report of sale by special master	379-385
1-(16)	Bid made by Select Theatres Corporation (numbered pages 357-359 above)	

Index to Record on Appeal

Exhibit		Pages of Original Record
1-(18)	Petition requesting confirmation of bid	386-389
1-(19)	Decree confirming said sale	390-396
1-(20)	Minutes of meeting of Board of Directors of 4/17/33	397-398
1-(21)	Amendment to subscription agreement between The Atel Co. Inc. and Select Theatres Corporation	399-405
1-(22)	Receivers report #16	406-417
1-(23)	Letter from Lee Shubert to creditors and stockholders of Shubert Theatre Corporation offering stock in Select Theatres Corporation	418-419
1-(24)	Minutes of meeting of Directors of Select Theatres Corporation 6/17/33	420-424
1-(25)	Subscription agreement between The Atel Co. Inc. and Select Theatres Corporation 6/17/33	425-432
1-(26)	Letter of transmittal used by 6% Gold Debenture holders	433-434
1-(27)	Letter of transmittal used by 6% Gold Debenture holders, under deposit agreement of 10/24/31	435-436
1-(28)	Letter of transmittal used by 6% Gold Debenture holders under deposit agreement of 6/16/31	437-438

Index to Record on Appeal

Exhibit		Pages of Original Record
1-(29)	Letter of transmittal used by 6% Gold Debenture holders under deposit agreement under plan of reorganization, dated 2/15/33	439-440 —4—
1-(30)	Letter of transmittal used by stockholders of Shubert Theatre Corporation	441
1-(31)	Letter of surrender used by said stockholders	442-443
1-(32)	Letter of transmittal used by unsecured creditors of said corporation	444
1-(33)	Release for unsecured creditors	445
1-(34)	Receivers application for discharge	446-468
1-(35)	Receivers report #20	469-476
1-(36)	List of properties lost by Select Theatres Corporation 4/25/33-6/30/40	477-478
2	Plan of adjustment 6/16/31	479-486
3	Plan of reorganization 2/15/33	487-500
4	Receivers report #1	501-681
5	Receivers report #2	682-700
6	Receivers report #3	701-716
7	Receivers report #4	717-726
8	Receivers report #5	727-762
9	Receivers report #6	763-776
10	Receivers report #7	777-789

Index to Record on Appeal

Exhibit		Pages of Original Record
11	Receivers report #8	790-798
12	Receivers report #9	799-818
13	Receivers report #10	819-832
14	Receivers report #12	833-865
15	Receivers report #13	866-867
16	Receivers report #14	867(a)-867(f)
17	Receivers report #15	868-909
18	Receivers report #17	910-912
19	Receivers report #18	913-921
		—5—
20	Receivers report #19	922-925
23	Paragraph 11 of report #15 (numbered as page 871 above)	
24	Stipulation—dated 2/9/55	missing
25	Five books of testimony	926-1050
Clerk's	Certificate	1051

Docket Entries

—B—

Oct. 6, 1949	Filed complaint and issued 60 day summons
Oct. 19, 1949	Filed summons and return—served Andrew Kelly, Ass't to deft 10/17/49; served Julius Rolnitzky, U. S. Attorney's Office, SDNY 10/17/49; served The Attorney General by registered mail 10/17/49.
Dec. 16–49	Filed stip. & order extending time to answer to 2/17/50—S. H. Kaufman, *J.*
Feb. 17–50	Filed stip. & order extending time to answer to 3/20/50—Sugarman, *J.*
Mar. 23–50	Filed stip. and order extending time to answer to 6-19-50—McGohey, *J.*
May 16–50	Filed answer of deft. (U. S. Atty.).
Oct. 28–53	Filed affdvt for adjournment.
Jan. 12–54	Filed affdvt for adjournment.
Oct. 19–54	Filed affdvt for adjournment.
Nov. 23, 1954	Pre-trial before Sugarman *J.* Hearing held & adj'd to 12/3/54.
Dec. 3, 1954	Pre-trial before Sugarman *J.* Hearing held Concluded—Order to be entered.
Dec. 8–54	Filed affdvt for adjournment.
Dec. 17–54	Filed pretrial order—Sugarman, *J.*
Feb. 4–55	Affdvt & notice of motion for adjournment —to top Day Cal. for 2-10-55—Memo endorsed 2-3-55—Granted—No opposition—Knox, *Ch.J.*
Feb. 14–55	Before Bicks, *J.*—Trial begun and concluded —Decision reserved.

Docket Entries

Oct. 1–56	Filed opinion #22,945 & judgment denying refund. Bicks, *J.* Mailed notice of entry 10-1-56.
Oct. 1–56	Filed Pltf's Stip.
Oct. 1–56	Filed Deft's Stip.
Oct. 1–56	Opinion No. 22945 docketed as judgment No. 61,183. on 10-22-56.
Oct. 22–56	Filed bill of costs taxed at $20.00.
Nov. 21–56	Filed pltff's notice of appeal—Mailed copy to US Atty. 11-23-56.
Nov. 21–56	Filed appeal bond—Etna Ins. Co.
Dec. 18–56	Filed transcript of record of proceedings of Feb. 14. 1955.

(Seal)

—111—

Opinion

#105

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

Civ. 52-331

SELECT THEATRES CORPORATION,

Plaintiff,

—against—

JAMES W. JOHNSON, Collector of Internal Revenue,

Defendant.

Appearances:

VICTOR R. WOLDER,
Attorney for Plaintiff,
347 Madison Avenue,
New York City.

J. EDWARD LUMBARD, United States Attorney for the Southern District of New York,
Attorney for Defendant,
United States Court House,
New York 7, N. Y.

THOMAS C. BURKE,
Assistant U. S. Attorney,
Of Counsel.

BICKS *D.J.*:

Plaintiff claims to have overpaid income and excess profits taxes for its fiscal year ended June 30, 1943 by

$143,069.79 and brings this suit to recover the alleged overpayment. Its right to prevail turns principally upon

—112—

whether certain of its assets were acquired in a tax-free reorganization.

The Internal Revenue Code of 1939, section 710, imposed a tax on the "adjusted excess profits net income" of corporate taxpayers. Broadly speaking, this was the taxpayer's net income for the year, reduced by a credit deemed to represent the normal or non-excess earnings. Taxpayers were permitted a choice of basis of computing the credit, either on average earnings during the pre-war period 1936 to 1939, or on a return on the amount of capital invested in the enterprise. Plaintiff chose to employ the latter method in determining its tax liability for the tax year under review. It asserts, however, that the credit was computed on what it erroneously conceived to be its "invested capital" with the result that the credit to which it was entitled was grossly understated.

For the fiscal year here involved plaintiff filed a consolidated income and excess profits tax return, covering the operations of itself and its twenty-two wholly-owned subsidiaries[1] which disclosed a liability for taxes in the

—113—

following amounts, all of which were paid:

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1 Plaintiff, during the taxable year, owned all of the issued and outstanding stock of the following corporations: Select Operating Corporation; Barrymore Theatre Corp.; Century Library, Inc.; Forrest Theatre Company of Phila.; Jayson Building Co. Inc.; Modern Theatre Corporation; 635 Greenwich Street Co., Inc.; 620 W. 47 St. Corp.; Stage Costumes, Inc.; Select Lake City Theatre Operating Co.; Acre Realty Co. Inc.; Louisville Amusement & Operating Co.; Opera Under the Stars, Inc.; Sam S. Shubert Amusement Co. Inc.; Walnut & Quince Sts. Corp.; Dec Theatre Corporation; Detroit Downtown Theatre Corporation; Performing Rights Society of the Theatre, Inc.; April Productions, Inc.; Continental Music Publishing Co. Inc.; Operatic Festival, Inc.; Ddot Theatre Corporation.

Opinion

Income Tax	$ 57,712.73
Declared Value Excess Profits Tax	2,352.74
Excess Profits Tax	132,178.18
	$192,243.65

On December 6, 1946 plaintiff filed a claim for refund of $44,963.42. An amended claim increasing the amount of refund demanded to $142,999.79,[2] was filed on July 16, 1948.

Section 718(a) of the Internal Revenue Code of 1939 provides that the invested capital credit is determined by referring to the property *paid into* the corporation "for stock or as paid-in-surplus, or as a contribution to capital," and including the same "in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange." Under Section 760 of the 1939 Code the basis to the transferee of property *transferred* in a tax-free exchange is determined by reference to the basis of such property in the hands of the transferor or predecessor corporation.[3] Plaintiff paid $400,000. for the assets in question. The basis thereof in the hands of its vendor was upwards of $4,000,000. In the tax return as filed taxpayer treated the

—114—

amount it paid for the assets as its invested capital. The claim for refund is predicated on an invested capital in an amount equal to the vendor's basis for said assets.

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2 The parties have stipulated, and the pre-trial order provides, that the computation of the amount, if any, to be recovered by plaintiff shall await the determination of the legal issues involved.

3 Internal Revenue Code of 1939, sections 760(a) and 113(a)(7).

Opinion

Shubert Theatre Corporation (referred to herein as "Shubert") was organized in 1924 for the purpose of taking over the theatrical enterprises which had been conducted for approximately twenty-five years by Messrs. Sam S., Lee and J. J. Shubert. It was one of the principal producers of so-called "legitimate" theatrical attractions in the United States and the largest operator of "legitimate" theatres. The business had been highly profitable and continued so through its fiscal year which ended June 30, 1929. The severe decline in the securities markets in the last quarter of 1929 and the general business depression which followed had a marked adverse effect on the theatrical industry, Shubert included. For the fiscal year ended June 30, 1930, it sustained a net loss of $1,231,000., for the succeeding fiscal year $1,672,000.; and for the period July 1, 1931 to October 20, 1931, $1,187,000.; a loss in the aggregate during this period of approximately twenty-eight months, of $4,090,000. Shubert then found itself unable to discharge its obligations as they matured with the result that on October 20, 1931, a bill of complaint in an equity receivership proceeding was filed in this court by a general creditor. Shubert's answer admitted the allegations of the

—115—

complaint and joined in the prayers for relief contained therein. Irving Trust Company, a New York banking corporation, and Lee Shubert, were thereupon appointed receivers.[4]

At the date the receivership proceedings were instituted Shubert's liabilities consisted of $6,360,000. 6% gold debentures due June 15, 1942; $323,000. accumulated inter-

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4 Subsequent to October 20, 1931, the receivership was extended to include all of Shubert's wholly-owned subsidiaries.

est on said debentures; $1,158,000. notes and accounts payable; Federal amusement taxes payable $9000.; and $284,000. deferred credits.[5] The capital stock consisted of 218,160 shares without par value of which 210,360 were issued and outstanding and 7800 were held in the treasury. Messrs. Lee and J. J. Shubert owned, either directly or indirectly, 71,680 shares of Shubert stock (34% of the total outstanding shares); $619,000. principal amount of Shubert 6% gold debentures (9.7% of the total outstanding debentures); and $660,000. of other debt.

—116—

During the operation of the business by the receivers the liquid assets continued to dwindle. In order to provide funds for payment of the expenses of administration and the continued operation of the business, the receivers were authorized in April 1932 to create a second issue[6] of interest bearing certificates of indebtedness or receiver's certificates in a principal amount not in excess of $400,000. maturing not later than March 1, 1933, and to sell all or any part thereof up to $300,000. in principal amount. The order provided, *inter alia,* that (i) the certificates shall not impose any personal liability on the receivers otherwise than as receivers of Shubert; (ii) the certificates shall be secured by (a) a direct charge upon the receivership estate,

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5 Mortgages on real estate totaling $10,749,000. and accrued interest thereon are omitted, it not appearing whether and to what extent, if any, Shubert was liable for deficiencies. Real estate taxes totaling $493,000. likewise are omitted—the City of New York may look for collection only to the property on which the tax liens attach. *Haight* v. *Mayor,* 99 N. Y. 280 (1885); *People ex rel. Meyers* v. *Moynahan,* 130 App. Div. 46 (1st Dept.), 114 N. Y. S. 417 (1909). See *Paddell* v. *City of New York,* 211 U. S. 446 (1908).

6 A first issue of certificates in the amount of $50,000. was sold during the period October 28, 1931 to February 1, 1932. These certificates were retired, with interest, and are not involved in this case.

(b) a lien upon all the assets in the possession of the receivers, subject and subordinate to all valid liens on any part of the assets covered thereby existing at the date of the appointment of the receivers, but prior and superior to the 6% gold debentures due June 15, 1942, and all other unsecured debts, (c) such charge and lien shall rank equally with the charge or lien of all other obligations of the receivers incurred in the operation of the business, except administration expenses, which, by operation of law, may be entitled to priority thereto, (d) such charge or lien shall not, so long as the receiver shall not be in default in the

—117—

payment of said certificates when due, limit or restrict the right of the receivers to dispose of any assets then in their hands or which may thereafter come in their hands in the conduct of the business, or to apply such assets or the proceeds thereof to the payment of expenses and indebtedness incurred by the receivers in the conduct of the business, (e) all the certificates, at the election of the holders thereof, shall become immediately due and payable upon any sale of the assets in satisfaction of any final decree and the termination of the receivership, or in the event that Shubert shall be adjudged bankrupt and (f) the receivers were authorized, by agreement with the holders of the certificates, to extend the maturity date for a period not exceeding three months from March 1, 1933.

The entire issue of said receivers' certificates was sold to The Atel Co., Inc., hereinafter referred to as "Atel." Atel was organized on March 23, 1932 under the Laws of the State of New Jersey. At least from May 1932 all its outstanding stock was owned by Dorsar Enterprises, Inc., a New York corporation, which was 100% owned by the Shuberts individually. The funds employed by Atel for the

purpose of purchasing the receivers' certificates came to it by loan from Dorsar Enterprises, Inc., the latter having previously borrowed a like sum from the Shuberts. Atel

—118—

was neither a stockholder nor creditor of Shubert or any of its subsidiaries.[7]

Efforts in the direction of effecting a reorganization met with no success. The amount of cash and the value of assets readily convertible into cash in the hands of the receivers continued to decline. In the opinion of the receivers further operation of the business might have resulted in further losses. Thus circumstanced, the receivers on January 4, 1933 recommended that the properties and assets in their hands be sold and the proceeds thereof distributed among those entitled thereto. Upon the petition of the receivers a decree was made under date of January 21, 1933, directing that, the assets be sold, either in bulk or in separate parcels, to the highest bidder or bidders (in case of a bulk sale an upset price of $400,000. was fixed); any creditor or any stockholder, director or officer of Shubert may purchase the assets in his own right, and Lee Shubert, one of the receivers, may likewise bid at such sale, or may be interested in any corporation that shall bid thereat and he or any such corporation may purchase the assets in his or in its own right provided that he shall have resigned as receiver prior to the date of the sale; and further, that

> "no sale of the * * * assets * * * shall be confirmed to any purchaser on behalf of, or for the benefit of,

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7 It does not appear from the record whether Dorsar Enterprises, Inc. was a stockholder or creditor of Shubert or any of its subsidiaries.

any corporation organized or to be organized with the intention that it shall become the owner of said * * * assets * * * pursuant to any plan or agreement of reorganization unless at or before the sale * * * such purchaser shall have filed with the Special Master a complete copy of such plan or arrangement * * * and no sale of any property * * * to any purchaser who is to purchase such property pursuant to any such plan or agreement shall be confirmed if the Court shall determine that the provisions of such plan * * * are inequitable * * * . So much of the purchase price as may not be required by the Court to be paid in cash may be paid in whole or in part by delivery to the Special Master, * * * outstanding Receivers' Certificates of Indebtedness and/or claims allowed * * * , including claims in respect of the 6% Gold Debentures * * * . The purchaser shall be credited on account of the purchase price with such sum * * * as would be payable in cash, out of the proceeds of the sale, in respect of said Receivers' Certificates of Indebtedness. Debentures, * * * and other claims, if the whole amount of the purchase price were paid in cash."

Lee Shubert removed any disqualification to become a bidder at the sale or interested in the purchaser by resigning as receiver. The sale pursuant to said decree originally scheduled for February 24, 1933 was adjourned from time to time to April 7, 1933. As a condition to the last adjournment Lee Shubert bound himself to bid or cause to be bid not less than $400,000. for the assets held in the receivership estate. At the sale the assets were struck down in bulk to the only bidder—Select Theatres Corporation, the plaintiff herein, for $400,000. Upon the Special

Master's report of sale and petition of the plaintiff herein a decree was entered confirming the sale. The petition recited that plaintiff intended to deliver the receivers'

—120—

certificates to the Special Master on account of the purchase price and prayed that the Special Master be directed to credit on account of the purchase price such sums as would be payable out of the proceeds of sale in respect of said receivers' certificates if the whole amount of the purchase price were paid in cash. The confirmatory decree authorized the Special Master to accept said certificates as pro tanto payment of the purchase price. It recited further

> "it appearing to the Court that said Select Theatres Corporation has not been organized with the intention that it shall become the owner of the properties and assets of defendants, or any part thereof, or any beneficial interest therein, pursuant to any plan or agreement of reorganization, and does not propose to purchase said properties and assets, or any part thereof, on behalf of, or for the benefit of, any other corporation organized or to be organized with such intention."

Select Theatres Corporation, the successful bidder, was organized on April 5, 1933, two days before the sale. Its original authorized capital stock consisted of 200 shares of common stock without par value. At its first meeting the Board of Directors accepted an offer by Atel to purchase 101 shares of its common stock for $404,000. to be paid, $300,000. by delivery of the receivers' certificates and the balance, less accrued interest on said certificates in cash. On April 17, 1933, the subscription agreement was

modified. Under the amended agreement Atel subscribed to 140 shares for $14,000. and agreed to loan to the com-

—121—

pany $390,000. (in cash and the aforesaid receivers' certificates) against its one year note.

The purchase at the Special Masters sale was consummated on April 25, 1933. Payment of the purchase price was made by delivery of the receivers' certificates duly endorsed, plus $90,009.52 in cash[8] representing the difference between the principal amount of the receivers' certificates plus accrued interest and the $400,000. purchase price. The cash proceeds of the sale were applied to the payment of expenses of administration by the estate in receivership after which no amount whatever remained available for distribution among the creditors or stockholders of Shubert.

On or about May 31, 1933 Lee Shubert addressed a communication to the creditors and stockholders of Shubert, stating in part:

> "When the Court decided that the assets of the Corporation were to be sold at public auction, we offered the security holders a plan of reorganization, but the subscriptions were insufficient to carry it through. Consequently, the assets were purchased by Select Theatres Corporation (in which I have a substantial interest) for the upset price fixed by the Court—$400,000. No other bidder appeared at the sale. The sale was confirmed by the Court, and the transfer of the assets has been substantially completed.

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8 This cash was obtained in the same manner as the cash originally employed to purchase the receiver's certificates, i.e., the Shubert partnership advanced the same to Dorsar Enterprises, Inc., which in turn advanced the funds to Atel, and the latter supplied them to plaintiff.

Opinion

"Select Theatres Corporation will be recapitalized with an authorized capital to consist of $400,000 of

—122—

6% non-cumulative preferred stock, which may be issued up to the full amount of the price paid for the properties ($400,000), and 200,000 shares of common stock, with a nominal par value, both classes of stock being entitled to one vote per share.

"The stockholders of Shubert Theatre Corporation will, of course, receive nothing as a result of the sale of the Corporation's assets. Debentureholders and other creditors are entitled to their pro rata share of the purchase price after payment of expenses and Receiver's obligations; but it now appears likely that very little, if anything, will be available for distribution to debenture holders and other creditors when the receivership is finally wound up.

"Nevertheless, it is my earnest desire that those who invested their money in Shubert Theatre Corporation, under my management, shall have an opportunity to participate in the new company, and to benefit with the return of prosperity, if such time arrives. Accordingly, I have arranged for the issuance of 50% of the common stock of Select Theatres Corporation to security holders and creditors of Shubert Theatre Corporation, without cost to them.

"This stock, the greater portion of which would otherwise become part of my personal holdings, will be distributed on the following bases:

10 shares of common stock of Select Theatres Corporation in respect of each $1,000 debenture (with June 15, 1931, and subsequent coupons attached) of Shubert Theatre Corporation;

1 share of common stock of Select Theatres Corporation in respect of each $105 of allowed claims against Shubert Theatre Corporation;

1 share of common stock of Select Theatres Corporation in respect of each 10 shares of common stock of Shubert Theatre Corporation.

—123—

* * * * *

"Security holders and creditors of Shubert Theatre Corporation availing themselves of this offer should forward their securities or allowed claims to me in care * * * I will not take title to the securities and claims so forwarded but, acting as agent for the holders thereof, will surrender them to Shubert Theatre Corporation for cancellation. No transfer stamps or other expenses will be payable by those who take advantage of this offer. The debentures and allowed claims will not be canceled until it is definitely known whether or not there will be anything available for distribution to the holders thereof. If anything should be available, I will collect the amount due upon the debentures and allowed claims surrendered by those who have accepted my offer, and will turn over to them the amounts which they are respectively entitled to, less expenses incurred by me in that connection."

To permit of issuance of the stock in accordance with said letter plaintiff caused its authorized capitalization to be modified to consist of 40,000 shares of 6% non-cumulative preferred stock par value $10.00 per share, and 200,000 shares common stock par value 10 cents per share. The 140 shares of common stock no par value, previously authorized to be issued, were exchanged for 1400 shares of preferred

stock. Atel's subscription agreement as previously amended was further modified. Instead of loaning plaintiff $390,000., Atel subscribed to 36,650 shares of preferred stock and 200,000 shares of common stock and agreed to pay therefor $366,500. and $20,000. respectively. 100,000 shares of said common stock were set aside for distribution to the debenture holders, general creditors and stockholders of

—124—

Shubert in accordance with the offer contained in Lee Shubert's letter. Of the shares of common stock thus set aside an aggregate of 79,731 shares were ultimately distributed among the holders of $5,472,000 principal amount of the 6% debentures (over 86% of the total amount outstanding); the holders of $692,963.20 face amount of general claims (over 63% of the total claims allowed in the receivership); and the holders of 175,361 shares of the capital stock of Shubert (over 82% of the number of shares outstanding), in the amounts and proportions set out in the aforementioned letter. The remaining 20,629 shares of common stock were ultimately issued to Atel. It would appear, therefore, that the cost to Atel of 38,050 shares of preferred stock and 120,269 shares of common stock, was $400,500. Ascribing to the preferred stock its par value, approximately 60% of the common stock of plaintiff cost Atel $20,000.

In response to an inquiry from a Shubert stockholder who had accepted the offer set forth in Lee Shubert's letter, plaintiff's treasurer under date of March 31, 1936, advised him that the shares of Select Theatres Corporation he received was purely a gratuitous offer by Lee Shubert, the stock did not originate from Shubert Theatre Corporation, the stock was not offered under any plan of reorganization and that the offer of stock was made subsequent

—125—

to the sale of the assets. The letter in full, is set forth in the margin.[9]

Plaintiff's origin and background have been developed at length because of the claim that, with these credentials plaintiff may gain entry into the golden circle of corporate legatees. The conclusion is inevitable, however, that its ancestor, Shubert, was put to death on the auction block under circumstances that plaintiff may not collect its claimed inheritance—a "basis windfall" giving it a basis for its assets far above the market value thereof at the time of acquisition and upwards of ten times the amount it paid for them.

Plaintiff does not, and indeed cannot, urge that the gratuitous distribution of a portion of its voting securities to former creditors and stockholders of Shubert was in pursuance of or constituted a plan of agreement of reorganization. Its claim in essence is that plaintiff's ownership of the receivers' certificates, the order authorizing the Spe-

—126—

cial Master to accept, and his acceptance of, the receivers' certificates as payment on account of the purchase price in lieu of cash, constituted a tax-free reorganization under Section 112 of the Revenue Act of 1932.

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9 "Your letter of March 27, 1936, addressed to Mr. Lee Shubert has been referred to me for attention. As former comptroller of the Shubert Theatre Corporation and as present Treasurer of the Select Theatres Corporation, I am in a position to give you the information requested.

"Your understanding that the ten shares of Select Theatres Corporation which you received, was purely a gratuitous offer by Mr. Lee Shubert, is correct. The stock did not originate from the Shubert Theatre Corporation nor was it offered to you under any plan of reorganization. The assets of the Shubert Theatre Corporation were sold in the receivership proceedings and were entirely insufficient to meet its debts and such sale did occur prior to the offer of the ten shares of stock."

This contention is challenged by the defendant. It urges that the ownership of the receivers' certificates did not confer upon plaintiff an "equity" in Shubert and that there is lacking the "continuity of interest" necessary to support a tax-free reorganization.

The 1932 Act, Section 112(j), defines a reorganization, insofar as here material, thusly:

> "The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of * * * substantially all the properties of another corporation) * * * "

Whether a transaction qualifies as a reorganization under the Revenue Act does not turn alone upon a compliance with the literal language of the statute. *Commissioner of Internal Revenue* v. *Gilmore's Estate,* 130 F. 2d 791 (3d Cir. 1942). The words of the statute within the parenthesis expand the meaning of "merger" or "consolidation" so as to include some transactions which partake of the nature of a merger or consolidation but are beyond the ordinary and commonly accepted meaning of those words—so as to embrace circumstances difficult to delimit but which in strictness cannot be designated as either merger or consolidation. *Pinellas Ice & Cold Storage Co.* v. *Commissioner,* 287 U. S. 462, 470 (1933). In the *Pinellas* case the

transfer of assets from one corporation to another for well secured short-term notes like the purchase for money of the assets of one company by another, was held to have no real resemblance to a merger or consolidation and beyond the evident purpose of the statute. It was subsequently held that the term of the obligation, whether long-term bonds or short-term notes is not material. *LeTulle* v. *Scofield,*

308 U. S. 415 (1940). Unless the transferor retains a definite and substantial proprietary interest in the enterprise,[10] the transfer does not amount to a reorganization within the true meaning of the statute, but is a sale upon which gain or loss must be reckoned. *Pinellas Ice & Cold Storage Co.* v. *Commissioner, supra; Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378 (1935); *LeTulle* v. *Scofield, supra.*

The problem of "continuity of interest" was considered by the Courts principally from the single aspect of what the old proprietors must receive in the new enterprise. But with the profusion of distress reorganizations engendered by the economic depression of the early 1930's it became necessary to explore another element of the problem, to wit, who are the old proprietors. The latter problem is the crucial one here.

—128—

The problem of the identity of the old proprietors was first presented to the Supreme Court in a group of cases decided in 1942. *Helvering* v. *Alabama Asphaltic Limestone Company,* 315 U. S. 179; *Palm Springs Holding Corporation* v. *Commissioner,* 315 U. S. 185; *Bondholders Committee etc.* v. *Commissioner,* 315 U. S. 189; *Helvering* v. *Southwest Consolidated Corporation,* 315 U. S. 194. The first two of said cases are the significant ones here.

In the *Alabama* case the respondent acquired all the assets of an insolvent corporation pursuant to a creditors plan of reorganization consummated with the aid of the bankruptcy court. At the sale by the bankruptcy trustee

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10 Receipt of preferred stock of the transferee corporation by the stockholders of the selling corporation has been held to represent a substantial continuation of their interest. *John A. Nelson Co.* v. *Helvering,* 296 U. S. 374 (1935).

the creditors committee was the successful bidder. The price was paid in substantial part by agreements of creditors to accept stock of a new corporation in full discharge of their claims and by an offer of the committee to meet the various costs of administration. Pursuant to the plan all the stock of the respondent was distributed among the creditors of the bankrupt company. The Government contended that the requisite continuity of interest was broken because the stockholders of the bankrupt corporation were eliminated by the plan (no portion whatever of their proprietary interest having been preserved for them in the new corporation) and hence there was "no reorganization." Recognizing that the old continuity of interest had been

—129—

broken, the Court held that it was

> "immaterial that the bankruptcy sale shifted the ownership of the equity in the property from the stockholders to the creditors of the old corporation. Plainly, the old continuity of interest was broken. Technically that did not occur * * * until the judicial sale took place. For practical purposes, however, it took place not later than the time when the creditors took steps to enforce their demands against their insolvent debtor. In this case, that was the date of the institution of bankruptcy proceedings. From that time on they had effective command over the disposition of the property. The full priority rule of *Northern P. B. Co.* v. *Boyd,* 228 U. S. 482, applies to proceedings in bankruptcy as well as to equity receiverships. *Case* v. *Los Angeles Lumber Products Co.,* 308 U. S. 106. It gives creditors, whether secured or unsecured, the right to exclude stockholders entirely from the reorganization plan when the debtor is insolvent. See *In*

Re 620 Church Street Bldg. Corp., 229 U. S. 24. When the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority. At that time they stepped into the shoes of the old stockholders. The sale 'did nothing but recognize officially what had before been true in fact.' *Helvering* v. *New Haven & S. L. R. Co.* (CCA 2d), 121 F. (2d) 985, 987."

The *Palm Springs* case was a companion one to the *Alabama* case and involved basically the same problem, although a different procedure was invoked to salvage the interest of the creditors. The decision in the *Alabama* case was held to be controlling. "The critical facts" held the Court "are that the old corporation was insolvent and that its creditors took effective steps to obtain command over its property. For the reasons stated in *Helvering* v.

—130—

Alabama Asphaltic Limestone Co., supra, the creditors at that time acquired the equivalent of the proprietary interest of the old equity owner. Accordingly, the continuity of interest test is satisfied."

In the *Alabama* and *Palm Springs* cases, and those which followed them,[11] there arrived some point in time when it could be said that ownership of the corporation shifted to the creditors. Typically, the change of ownership takes

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11 See, e.g., *Templeton's Jewelers, Inc.* v. *United States*, 126 F. 2d 251 (6th Cir., 1942); *Rotenberg* v. *Sheehan*, 48 F. Supp. 584 (E. D. Mo., 1943), appeal dismd., 144 F. 2d 992 (8th Cir. 1944); *Braicks* v. *Hendricksen*, 43 F. Supp. 254 (W. D. Wash., 1942), aff'd 137 F. 2d 632 (9th Cir. 1943); *Connohio, Inc.*, 9 T. C. M. 1105, 1950; *Peabody Hotel Company*, 7 T. C. 600 (1946). See also *Helvering* v. *Cement Investors, Inc.*, 316 U. S. 527 (1942).

the form of an assumption of control by a creditors committee, or by an indenture trustee acting for the benefit of bondholders after the formulation of a reorganization plan. The exercise by the creditors of their rights of priority, and of their right to take over the corporate assets to the exclusion of the stockholders, works a transfer of dominion which puts them in the place of the stockholders. When, following the bankruptcy or receiver's sale, the creditors take over the assets of the corporation and become the stockholders of the new corporation, they are merely continuing an equity relationship which had by then already existed.

—131—

This rationale is consistent with the concept reflected on a corporate balance sheet and stems from the relationship between a corporation and its creditors. On one side of the balance sheet there is set forth the assets of the corporation and on the other, first the interests of the creditors—the liabilities, and then those of the equity owners—whatever remains after deducting the liabilities from the assets. This balance is the capital of the corporation. Those who deal with the corporation look to its capital funds as a source of and security for payment of the debts due them. If insolvency intervenes and the creditors take effective steps to enforce their demand via a foreclosure or bankruptcy or reorganization proceeding they step into the shoes of the stockholders *vis a vis* the interests or equity of the latter in the totality of rights and assets of the company.

No case has been cited by counsel and independent research by the Court has failed to find one dealing with the status of a holder of receiver's certificates as a party to a reorganization. The dissimilarity between the origin and rights of the certificate holder and those of the corporate

creditor make apparent that the reasons for relating creditors to stockholders are absent in the case of the former. The certificate holder did not deal with Shubert as such. The loan which is evidenced by the certificates was made to the receivers and not to Shubert. The rights

—132—

of the certificate holder did not derive from Shubert and the ownership thereof carried with it no right to take any action against Shubert in the event the certificates remained unpaid. The receivers' certificates were not absolute promises to pay nor debts of Shubert. They were debts of the receivers in their official capacity backed by the pledged faith of the Court that the proceeds of the property on which they were a charge, to the extent they were sufficient for that purpose, would be applied to their payment. See Clark, Receivers §§459, 461 (2d ed. 1929).

Until the sale the receivers were, both in fact and in legal contemplation, attempting to rehabilitate Shubert for the benefit of its creditors existing at the time of the institution of the proceeding. In view of its insolvency only the creditors held the equity in Shubert during the receivership. Nor does the fact that the certificates were secured by a charge or a "lien" on the property of Shubert in the hands of the receivers add weight to the suggestion that the certificate holder possessed or exercised a proprietary interest. It was not such a lien as conferred powers of foreclosure or control. To say that the holders had a "lien" is to say only that they had a right to repayment out of whatever assets were available for that purpose prior to the unsecured creditors of Shubert. Until there is a default, a creditor's interest is not the equivalent of a proprietary interest notwithstanding that upon default the creditor may also enforce a lien upon specific

—133—

property. True, insolvency of the debtor operates as an anticipatory breach of an executory agreement (*Rohem* v. *Horst,* 178 U. S. 1 (1900); *Central Trust Co.* v. *Chicago Auditorium Association,* 240 U. S. 581 (1916)) but here the certificate holder well knew it was making a loan to an insolvent estate in receivership. No term may be implied therefore, that the borrower would not permit itself through insolvency to become disabled from meeting its engagement. Absent such term, expressed or implied, the doctrine of anticipatory breach may not be invoked. Here the receivers' certificates were not due when the Special Master's sale was scheduled to be held. As already indicated Lee Shubert individually committed himself to bid an amount sufficient to discharge in full the receivers' certificates with interest—an undertaking which the certificate holder was content to accept. Under the circumstances its interests could in no wise be affected by Shubert's insolvency.[12] Payment in full when due with interest having been satisfactorily provided for, the rights of the certificate holder were akin to those of a creditor of a solvent debtor. The best that can be urged (without intimating, however, that such a contention is sound) is that the certificate holder had a mere possibility of a proprietary interest but that, as the Court said in the

—134—

Alabama case, "is, of course, not its equivalent." Taking full account of the steps involved in the issuance of the certificates, the rights which they conferred and the use to which they were put to acquire the Shubert assets, there

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12 "A plan does not 'affect' the claims of creditors when they retain exactly what they had before." *Gross* v. *Bush Terminal Co.,* 105 F. 2d 930, 932 (2d Cir., 1939).

was no point in time prior to the receiver's sale when it can be said that plaintiff, as the holder of the certificates, had the right to or took effective command of the Shubert assets.

Plaintiff's brief argues that there is "no substantial difference whatever" between the instant case and *Minneapolis, Northfield & Southern Railway* v. *Klem,* 117 F. Supp. 325 (D. Minn. 1953), aff'd 225 F. 2d 909 (8th Cir. 1955). In that case, a sufficient continuity of interest was found to exist despite changes in the ownership of creditors' claims during the pendency of the proceeding. As assignees, the new holders of the claims were held to be clothed with the same creditors rights and powers as had inured to their assignors. The new holders of the claims which antedated the commencement of the proceeding, were not divested of their right to reorganize the company merely because they became owners during the pendency of the proceeding. The *Minneapolis* case is similar to the case at bar in that the assignees of the creditors' claims, like the holder of the receivers' certificates, acquired their respective rights after the institution of the proceedings. Here, however, the similarity ends. In the case at bar, with respect to plaintiff's assignor—the original holder of the receivers' certificates—continuity of interest was lacking; in *Minneapolis* with respect to the assignors—creditors whose claims arose out of dealings with the corporation prior to the institution of the proceeding—continuity of interest existed.

The facts are, of course, that as matters eventuated, there were no bidders at the Special Master's sale for the assets in separate parcels, they were struck down in bulk, the successful bidder was the holder of the receivers' certificates, the same were applied on account of the purchase

price, and the purchaser has continued the business enterprise. The circumstance that at or about the time of the sale plaintiff acquired the receivers' certificates and obtained permission to apply them on account of the purchase price did not alter its status as a cash purchaser nor confer benefits upon it different than those that would inure to any cash purchaser. Indeed, its bid was for a fixed sum payable in cash and but for its application for leave to pay part of the purchase price by surrendering the certificates, they would have been fully discharged by payment in cash.

Before the Special Master's sale the certificate holder had no rights to the ownership of the assets in the hands of the receiver. Whatever rights of ownership it ultimately acquired stemmed from, and did not pre-date, the sale. The continuity of interest, therefore, was broken and no reorganization occurred.

—136—

This leaves for consideration plaintiff's alternate position that if it is not entitled to include in its equity invested capital Shubert's basis of the assets it purchased at the Special Master's sale, it is entitled to include the basis of the stock, debentures and unsecured claims of Shubert in the hands of those who accepted the offer contained in the Lee Shubert letter discussed *supra*. Reliance for this alternate position is placed on §113(a)(8)(B) of the Internal Revenue Code.[13] This position is clearly untenable:

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13 "Sec. 113 * * * (a) BASIS (UNADJUSTED) OF PROPERTY.—The basis of property shall be the cost of such property; except that—

(8) PROPERTY ACQUIRED BY ISSUANCE OF STOCK OR AS PAID-IN SURPLUS.—If the property was acquired after December 31, 1920, by a corporation— * * *

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the

Opinion

(1) Plaintiff acquired no property from the old stockholders and creditors who accepted Lee Shubert's offer. The offer was wholly gratuitous, was made by Lee Shubert individually, not by the plaintiff, and was made after the acquisition of the assets. Under the terms of the letter those who accepted the offer transferred no property to anybody, certainly not to the plaintiff. "Security holders and creditors of Shubert Theatre Corporation," wrote Lee Shubert "availing themselves of the offer should forward their certificates or allowed claims to *me* * * * . *I* will not

—137—

take title to the securities so forwarded, but, acting as agent for the *holders* thereof, will surrender them to Shubert Theatre Corporation for cancellation." If any contribution was made by the old stockholders and creditors —and none could have been made since after the sale the old stock and the claims of creditors were valueless—it was made to Lee Shubert, not to the plaintiff. But there was no intention to pay in surplus or make a contribution to the capital of either Shubert or plaintiff—witness the following from Lee Shubert's letter "The debentures and allowed claims will not be canceled until it is definitely known whether or not there will be anything available for distribution to the holders thereof. If anything should be available, I will collect the amount due upon the debentures and allowed claims surrendered by those who have accepted my offer, and will turn over to them the amounts which they are respectively entitled to, less expenses incurred by me in that connection." and his earlier statements in said letter "I have arranged for the issuance

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amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made."

of common stock of Select Theatres Corporation to security holders and creditors of Shubert Theatre Corporation, without cost to them. This stock * * * would otherwise become part of my personal holdings. * * * " (2) Plaintiff did not issue any stock to the old stockholders and creditors who accepted Lee Shubert's offer. The stock which was delivered to them had been subscribed to and fully paid for by Atel which was entitled to have the same issued to it

—138—

or its nominees. In delivering the stock, it was acting pursuant to the instructions of and as agent for Atel. The delivered stock was stock *of* the plaintiff, but not *its* stock. The facts here are wholly without the provisions of section 113.

Plaintiff suggests that Lee Shubert's offer to distribute stock which otherwise would be part of his personal holdings was not wholly gratuitous, but was made to avert possible claims of creditors under the "absolute priority" rule of *Northern Pacific R. Co.* v. *Boyd,* 228 U. S. 482 (1913). Assuming, without deciding the question, that the offer was prompted by such a motive, it still does not follow that an after-thought may rise to the dignity of a pre-conceived plan of reorganization or justify invoking section 113 of the Internal Revenue Code. An attempt to forestall claims and to provide insulation to the stockholders of the new corporation from suit by giving the Shubert creditors a minor interest in the new corporation is not tantamount either to a reorganization or the acquisition of property by the new corporation by issuance of stock or as paid in surplus or as a contribution to capital. The requisite continuity of interest must flow from rights recognized in a plan, otherwise the continuity is broken. Its existence must be determined by reference to facts as they

occurred and not legal rights which might have been, but were not, asserted. (Cf. *Templeton's Jewelers, Inc.* v. *United States,* note (11) *supra.*)

—139—

Plaintiff acquired the Shubert assets by purchase and not in furtherance of a tax-free reorganization. The basis it ascribed thereto in its tax return as filed was correct and the claim for refund is denied.

The foregoing shall constitute Findings of Fact and Conclusions of Law in accordance with Fed. R. Civ. P. 52(a).

Dated: September 29, 1956.

ALEXANDER BICKS
United States District Judge.

10/1/56
Judgment Entered

HERBERT A. CHARLSON
Clerk

10/22/56—Costs taxed on the sum of $20.00.

HERBERT A. CHARLSON
Clerk

Supreme Court, U.S.
FILED
FEB 11 1958
JOHN T. KEY, Clerk

Supreme Court of the United States

Term 1958

No. 781

SELECT THEATRES CORPORATION,

Petitioner,

—against—

JAMES W. JOHNSON, COLLECTOR OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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New York 17, New York

INDEX

PAGE

Petition for Writ of Certiorari 1

Conclusion 23

Appendix 25

Section 112(i) of the Revenue Act of 1932 25

Section 113(a)(7) of the Revenue Act of 1932 25

Section 113(a)(7)(A) of the 1939 Internal Revenue Code, as amended 26

Section 113(a)(12) of the 1939 Internal Revenue Code, as amended 27

Section 718(a) of the 1939 Internal Revenue Code, as amended 27

Section 760 of the 1939 Internal Revenue Code, as amended 28

Opinion by Bicks, D.J. 30

Per Curiam Opinion of the U. S. Court of Appeals (2nd Cir.) 56

Authorities Cited

Alabama Asphaltic Limestone Company v. Commissioner, 315 U. S. 179 (1942) 12, 13, 15, 16

Bondholders Committee, etc. v. Commissioner, 315 U. S. 189 13

Case v. Los Angeles Lumber Products Co., 308 U. S. 106 19

PAGE

Helvering v. Minnesota Tea Company, 296 U. S. 378 ....12, 13
Helvering v. Southwest Consolidated Corporation, 315 U. S. 194 (1942) 12, 13, 22
Helvering v. Watts et al., 296 U. S. 387 12

John A. Nelson Company v. Helvering, 296 U. S. 374 ..12, 13

Minneapolis, Northfield and Southern Railway v. Klem, 117 F. S. 325, aff'd 225 F. (2) 909 .....12, 16, 17

Northern P. B. Co. v. Boyd, 228 U. S. 482 ....7, 12, 17, 18, 22

Palm Springs Holding Corporation v. Commissioner, 315 U. S. 185 .....12, 13, 15, 16
Pinellas Ice and Coal Storage Co. v. Commissioner, 287 U. S. 462 (1933) 13

LeTulle v. Scofield, 308 U. S. 415 (1940) 13
Louisville Trust Co. v. Louisville, N. A. & C. R. Co., 174 U. S. 683 19

Roosevelt Hotel Co. v. Commissioner, 13 T. C. 399 22

Scofield v. San Antonio Transit Co. (C. C. A. 5th), 219 F. (2) 149, cert. den. 350 U. S. 823 13
St. Louis & San Francisco Railroad Co. v. Schiller, 274 U. S. 304 .....7, 18-19

Other Authorities:

28 U. S. C., Sections 1254(1) and 2101(c) 2

28 U. S. C., Sections 1331 and 1340 11

1932 Revenue Act, Section 112(i) 12

33 Sup. Ct. Rpt., page 561 23

Supreme Court of the United States

Term 1958

No. .....

SELECT THEATRES CORPORATION,

Petitioner,

—against—

JAMES W. JOHNSON, COLLECTOR OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Petitioner-in-the above case prays for the issuance of a Writ of Certiorari to the United States Court of Appeals for the Second Circuit to review the judgment of that court, and as its petition sets forth the following:

1. The per curiam opinion (copy appended hereto) of the Court of Appeals for the Second Circuit is not yet reported. The opinion of Judge Alexander Bicks of the United States District Court for the Southern District of New York, which was affirmed by the Court of Appeals, is reported in 145 Fed. Supp. 583.

2. The judgment sought to be reviewed is dated and was entered by the court below on December 3, 1957.

3. There was no order at any time made respecting a rehearing; nor was there any order granting an extension of time within which to petition for certiorari.

4. The jurisdiction of this court is sought to be invoked under Sections 1254(1) and 2101(c) of the Judicial Code (28 U. S. C.).

5. The question presented for review is as follows:

> "For the purpose of computing its fiscal year 1943 excess profits tax credit based on the invested capital method, did a tax free reorganization take place with respect to the assets Petitioner acquired from its predecessor, the Shubert Theatre Corporation, so as to entitle Petitioner to use the cost basis of the assets as they were in the hands of its aforementioned predecessor, adjusted within the purview of Section 760 of the 1939 Internal Revenue Code as amended, * * * "

6. Attached as part of the appendix hereto are the following sections of statutes which the case involves:

(a) Section 112(i) Revenue Act of 1932;

(b) Section 113(a)(7) Revenue Act of 1932;

(c) Section 113(a)(7)(A) Internal Revenue Code 1939 as amended;

(d) Section 113(a)(12) Internal Revenue Code 1939 as amended;

(e) Section 718(a)(1) and (2) Internal Revenue Code 1939 as amended;

(f) Section 760 Internal Revenue Code 1939 as amended.

7. Statement of facts material to case:

The Shubert Theatre Corporation, hereinafter referred to as the "Old Corporation," profitably operated in the legitimate theatre business for many years. Beginning in

1929, however, its business started to decline as the economic condition of the country became worse. In October 1931 it consented to the appointment of a receiver in an equity receivership proceeding brought against it by unsecured creditors in the United States District Court for the Southern District of New York. Lee Shubert and the Irving Trust Company were appointed the receivers. At that time the old corporation assets which had a book value of approximately $20,000,000, which were subject to various liens of mortgages, real estate taxes and the like of about $10,000,000. It also had outstanding unsecured liabilities consisting of unsecured debentures, unsecured notes, accounts payable and the like totalling approximately $8,000,000. There were also 210,300 shares of capital stock outstanding.

The business continued to operate in the hands of the receivers. Various creditor and stockholder committees were formed.

After concluding that if a liquidation of the business took place, a dividend of only 4% or less might be received by the $8,000,000 of unsecured creditors, a plan for the continuation of the business with a view to a possible reorganization was proposed by Lee Shubert, submitted to the court and thereafter adopted; and to this plan either all the creditors consented or did not object. The plan among other things provided for the receiver borrowing $300,000 based on receivers' certificates which would be a lien on all of the assets of the business and be made prior in right over and above the unsecured creditors. As part of the plan which was offered, it was specifically pointed out as follows:

> "from the very nature of the enterprise however, especially in the present general business condition, and because the plan involved the borrowing of a relatively

large sum of money, the proposal is hazardous and it may result in the holders of the receivers' certificates of indebtedness automatically coming into possession of all of the residue of the property, without the payment of any dividend to general creditors. The Committees and other representatives of creditors who have expressed their approval of continuation of the business have been advised of these considerations."

All of the receivers' certificates were sold by the receivers between June 1932 and October 1932 to the Atel Company, Inc., a corporation hereinafter referred to as "Atel." All of the capital stock of Atel was owned by Dorsar Enterprises, Inc., a corporation hereinafter referred to as "Dorsar" which was owned 100% by a partnership of which Lee and J. J. Shubert were the sole co-partners, fifty-fifty. The funds employed by Atel for the purpose of purchasing the receivers' certificates came to it by loan from Dorsar, which in turn had the money advanced to it by the Shubert co-partnership.

All the monies borrowed on the receivers' certificates were used in the business. However, conditions went from bad to worse with the result that in January 1933 after hearings were held, an order was made by the court directing the sale at public auction of all the assets. An upset price of $400,000 was fixed by the Court, to cover the outstanding receivers' certificates, plus administration expenses. The order of sale also permitted the receivers' certificates to be credited against the purchase price to the extent that the Court did not require the bid price to be paid in cash.

Some efforts had been made without success to reorganize the business. Prior to the Old Corporation going into receivership, two different plans of readjustment of

its capital structure had been sought to be made but without success. In late 1932 a reorganization committee was formed. In February 1933 a reorganization plan was promulgated by the Committee but this proposed plan had to be abandoned two days before the sale of the assets which took place on April 7, 1933 because of lack of necessary subscriptions. This plan of reorganization would have placed the receivers' certificate holders in a priority position in the proposed reorganization company and gave them preferred stock as well as common stock.* A statement made by the reorganization committee in said plan said

> "* * * and it is questionable whether the properties and assets in the possession of the Receivers can be sold for more than enough to satisfy the obligations of the Receivers, it is probable that unless the following or a similar plan is consummated the creditors may realize nothing whatsoever on the obligations held by them."

While all this was going on, however, in January of 1933 as part of the hearings in connection with the proposed sale of the assets, Mr. Lee Shubert (who was then one of the Receivers) through his attorney in open court stated as follows:

> "It is Mr. Shubert's desire that a plan of reorganization shall be worked out which will permit the creditors of Shubert Theatre Corporation to participate in such successor company. Efforts have been made in connection with certain groups of the creditors, to work out a satisfactory reorganization plan. So far, such plan has not been successfully worked out. *If, in*

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* The unsecured creditors were given common stock and rights to subscribe to some new common and preferred. The older stockholders were merely given a right to subscribe to new common and preferred.

collaboration with the several committees, it is impossible to work out such a plan, it is Mr. Shubert's intention to propose a plan on his own account and, if it is in any way possible to do so, to admit all of the creditors of the estate to some kind of participation in a reorganization company." (Italics ours.)

In March, Lee Shubert removed any disqualification to become a bidder at the sale or to be interested in the purchaser, by resigning as a receiver. In his application to resign Mr. Shubert made the following statement:

"Now that the property of said Shubert Theatre Corporation and the other corporations defendants herein have been decreed to be sold, it would seem probable that the main purpose of the receivership has been accomplished. It is further apparent that by virtue of your petitioner's investments in the Shubert Theatre Corporation and the other defendants corporations *the petitioner is vitally interested and desires to participate in the purchase of the assets of said defendants at said sale and in the reorganization of the defendant and in the reorganization of the properties so to be sold.*" (Italics ours.)

The Petitioner in this case is a corporation which was formed by Atel for the purpose of buying in the assets of the Old Corporation. On April 7, 1933 the Petitioner at a duly advertised and well publicized public auction sale bought in all the assets of the Old Corporation for a bid price of $400,000 which was the upset price fixed by the court. On April 25, 1933 Petitioner took title to all of the assets of the Old Corporation and as provided in the order which authorized the sale, it paid for the same using the $300,000 of receivers' certificates, $10,000 of accrued interest and $90,000 of cash. The sole stockholder of Peti-

tioner at this time was Atel which also transferred the necessary cash and receivers' certificates to the Petitioner in order to enable Petitioner to consummate the acquisition of all of the assets of the Old Corporation. The additional $90,000 cash which Atel advanced to Petitioner was obtained in the same manner as the cash originally employed to purchase the receivers' certificates, to wit: The Shubert partnership advanced the same to Dorsar which in turn advanced the same to Atel, which in turn advanced the same to Petitioner.

The value of the assets purchased did not exceed $400,000.

During the course of the equity receivership proceedings, at the sale and for a number of months prior to the sale counsel for the Petitioner, the Old Corporation, the Receivers, Lee Shubert and J. J. Shubert were aware of and familiar with the doctrine of the *Boyd* case (228 U. S. 482) and *St. Louis & San Francisco Railroad Co.* v. *Schiller* case (274 U. S. 304). The doctrine of the *Boyd* case is set forth at length beginning at page 18 of this brief. Under the doctrine of this case, subordinate rights of Lee and J. J. Shubert as stockholders and general creditors of the Old Corporation would have been deemed to have been secured at the expense of prior rights of prior general creditor and other shareholder; and hence void. Therefore the other general creditors and stockholders of the Old Corporation would have had a continuing interest. An offer had to be made to all of them.

On May 31, 1933 Lee Shubert wrote the stockholders and unsecured creditors of the Old Corporation a letter which said:

> "When the Court decided that the assets of the Corporation were to be sold at public auction, we offered the security holders a plan of reorganization, but the subscriptions were insufficient to carry it

through. Consequently, the assets were purchased by Select Theatres Corporation (in which I have a substantial interest) for the upset price fixed by the Court—$400,000. No other bidder appeared at the sale. The sale was confirmed by the Court, and the transfer of the assets has been substantially completed.

"Select Theatres Corporation will be recapitalized with an authorized capital to consist of $400,000 of 6% non-cumulative preferred stock, which may be issued up to the full amount of the price paid for the properties ($400,000), and 200,000 shares of common stock, with a nominal par value, both classes of stock being entitled to one vote per share.

"The stockholders of Shubert Theatre Corporation will, of course, receive nothing as a result of the sale of the Corporation's assets. Debenture holders and other creditors are entitled to their pro rata share of the purchase price after payment of expenses and Receiver's obligations; but it now appears likely that very little, if anything, will be available for distribution to debenture holders and other creditors when the receivership is finally wound up.

"Nevertheless, it is my earnest desire that those who invested their money in Shubert Theatre Corporation, under my management, shall have an opportunity to participate in the new company, and to benefit with the return of prosperity, if such time arrives. Accordingly, I have arranged for the issuance of 50% of the common stock of Select Theatres Corporation to security holders and creditors of Shubert Theatre Corporation, without cost to them.

"This stock, the greater portion of which would otherwise become part of my personal holdings, will be distributed on the following bases:

10 shares of common stock of Select Theatres Corporation in respect of each $1,000 debenture (with June 15, 1931, and subsequent coupons attached) of Shubert Theatre Corporation;

1 share of common stock of Select Theatres Corporation in respect of each $105 of allowed claims against Shubert Theatre Corporation;

1 share of common stock of Select Theatres Corporation in respect of each 10 shares of common stock of Shubert Theatre Corporation.

"Security holders and creditors of Shubert Theatre Corporation availing themselves of this offer should forward their securities or allowed claims to me in care * * * I will not take title to the securities and claims so forwarded but, acting as agent for the holders thereof, will surrender them to Shubert Theatre Corporation for cancellation. No transfer stamps or other expenses will be payable by those who take advantage of this offer. The debentures and allowed claims will not be cancelled until it is definitely known whether or not there will be anything available for distribution to the holders thereof. If anything should be available, I will collect the amount due upon the debentures and allowed claims surrendered by those who have accepted my offer, and will turn over to them the amounts which they are respectively entitled to, less expenses incurred by me in that connection."

As a result of the sending of this letter, Petitioner's capitalization was modified to consist of 40,000 shares of preferred stock, $10.00 par value and 200,000 shares of common stock 10¢ par value per share. 79,731 shares of common stock were issued in accordance with Lee Shu-

bert's letter aforementioned to the unsecured creditors and stockholders of the Old Corporation who accepted the offer, to wit: Over 86% of the holders of unsecured debentures, over 63% of holders of other unsecured claims, and over 82% of the number of the outstanding shares of the Old Corporation accepted Lee Shubert's offer. 38,050 shares of preferred stock were and 120,269 shares of common stock were issued to Atel.*

Petitioner has ever since continued to operate the assets and business it acquired from the Old Corporation.

After the distribution, Petitioner's capital stock was owned as follows:

Petitioner's Stock	*Relationship of New Owners to Old Corporation*
100% Preferred Stock and 60% Common Stock	was issued to Atel which owned 100% of the Receivers' Certificates, and which was indirectly owned by persons who were large creditors and stockholders of the Old Corporation
32 1/2% Common Stock	was issued to persons who owned over 76% of general unsecured creditors' claims against the Old Corporation
7 1/2% Common Stock	was issued to persons who constitute holders of 82% of capital stock of Old Corporation

All of these facts with relation to the offer of stock to the creditors and stockholders of the Old Corporation was reported to the Court by the Receivers in its Receivers Report #15 and said report of the Receivers was approved on April 10, 1934 by the same court order which approved

* This included 23,948 shares which creditors and stockholders of the Old Corporation did not pick up.

the transfer of the assets to Petitioner and the crediting of the receivers' certificates against the purchase price.

Based upon the law as it existed in 1933 at the time the transfer was made, it is Petitioner's contention that a tax free reorganization took place because one corporation acquired all of the assets of another corporation and there was continuity of proprietary interest. The District Court below held adversely to the Petitioner saying that continuity of interest did not exist because Petitioner was a mere purchaser; that Petitioner was not a creditor or stockholder of the Old Corporation, and that the interest that anyone acquired through the medium of the receivers' certificates could not be a basis for establishing continuity of proprietary interest; that a sale took place and there was no reorganization. The District Court also held that the distribution of stock made to the old creditors and stockholders could not be considered continuity of interest notwithstanding the fact that after the distribution was made the persons who constituted 100% stockholders of the Petitioner constituted the same persons who had not less than 100% of the receivers' certificate holders, over 76% of the unsecured creditors of the Old Corporation, and over 82% of stockholders of the Old Corporation. It is Petitioner's position that the Court of Appeals below erred when it affirmed the District Court's determination.

8. The federal jurisdiction in the Court of first instance was Sections 1331 and 1340 of Title 28 U. S. C. This case is a civil action wherein the matter in controversy exceeds the sum of $3,000 exclusive of interest and costs, and arises under the laws of the United States. It is a suit for the refund of excess profits taxes paid by Petitioner under the Internal Revenue Laws of the United States.

9. Argument relied on for the allowance of the Writ. The Writ should be allowed for the following reasons as noted below.

(a) The court below has decided a federal question in a way in conflict with applicable decisions of this court, i.e.: The doctrine of the *Alabama Asphaltic Limestone Company* case (315 U. S. 179) as set forth in *Palm Springs Holding Corporation* v. *Commissioner* (315 U. S. 185).

(b) The court below has rendered a decision in conflict with the decision of another Court of Appeals on the same matter, i.e.: 8th Circuit, *Minneapolis, Northfield and Southern Railway* v. *Klem,* 117 F. S. 325 aff'd 225 F. (2) 909.

(c) The court below had decided an important federal question in a way in conflict with applicable decision of this court in the case of *Northern P. B. Co.* v. *Boyd* (228 U. S. 432).

(A) THE COURT BELOW HAS DECIDED A FEDERAL QUESTION IN A WAY WHICH IS IN CONFLICT WITH THE HOLDINGS OF THIS COURT IN THE CASES OF *ALABAMA ASPHALTIC LIMESTONE COMPANY* v. *COMMISSIONER,* 315 U. S. 179 (1942); *PALM SPRINGS HOLDING CORPORATION* v. *COMMISSIONER,* 315 U. S. 185 (1942); *HELVERING* v. *SOUTHWEST CONSOLIDATED CORPORATION,* 315 U. S. 194 (1942); AND ALSO *HELVERING* v. *MINNESOTA TEA COMPANY,* 296 U. S. 378; *JOHN A. NELSON COMPANY* v. *HELVERING,* 296 U. S. 374; *HELVERING* v. *WATTS ET AL.,* 296 U. S. 387.

Section 112(i) of the 1932 Revenue Act provided that a reorganization occurred when one corporation acquired substantially all the assets of another corporation. This

court held however that the reorganization did not merely turn upon the literal language of the statute but that continuity of a proprietary interest had to be present. *Pinellas Ice and Coal Storage Co.* v. *Commissioner,* 287 U. S. 462 (1933); *LeTulle* v. *Scofield,* 308 U. S. 415 (1940). Just what circumstances might constitute continuity of interest have been defined by this court as "difficult to delimit." *Pinellas Ice and Coal Storage Co.* v. *Commissioner, supra.*

As the Court of Appeals, Fifth Circuit said in *Scofield* v. *San Antonio Transit Co.* (C. C. A. 5th), 219 F. (2) 149, cert. den. 350 U. S. 823:

> "The Courts do not purport to express any precise ironclad rule against which 'Continuity of interest' can be measured in every case. Compositely the cases mean simply that the facts must be presented from which it can reasonably be concluded that the new corporation is in substance the old enterprise in a new form."

There have been a large number of holdings that dealt with the subject matter of whether the transferor retained a substantial proprietary interest in the continuing enterprise. *Helvering* v. *Minnesota Tea Company, supra; John A. Nelson Co.* v. *Helvering, supra.* However, the problem of the identity of who really constituted the old proprietors of the assets which were transferred was presented to this Supreme Court in a group of cases decided in 1942. *Alabama Asphaltic Limestone Co.* v. *Commissioner, supra; Palm Springs Holding Corporation* v. *Commissioner, supra; Bondholders Committee, etc.* v. *Commissioner,* 315 U. S. 189 and *Helvering* v. *Southwest Consolidated Corporation,* 315 U. S. 196. In the *Alabama* case the respondent acquired all the assets of an insolvent corporation pursuant to a creditor's plan of reorganization consummated with the aid of the bankruptcy court. At the

sale by the bankruptcy trustee the creditors' committee was the successful bidder. The bid price was paid in substantially by agreements of creditors to accept stock of a new corporation in full discharge of their claims and by an offer of the committee to meet the various costs of administration. Pursuant to the plan, all the stock of the respondent was distributed among the creditors of the bankrupt company. The Government contended that the requisite continuity of interest was broken because the stockholders of the bankrupt corporation were eliminated by the plan (no portion whatever of their proprietary interest having been preserved for them in the new corporation), and hence there was no "reorganization." Recognizing that the old continuity of interest had been broken this court held that it was

> "immaterial that the bankruptcy sale shifted the ownership of the equity in the property from the stockholders to the creditors of the old corporation. Plainly, the old continuity of interest was broken. Technically that did not occur * * * until the judicial sale took place. For practical purposes, however, it took place not later than the time when the creditors took steps to enforce their demands against their insolvent debtor. In this case, that was the date of the institution of bankruptcy proceedings. From that time on they had effective command over the disposition of the property. The full priority rule of *Northern P. B. Co.* v. *Boyd,* 228 U. S. 482, applies to proceedings in bankruptcy as well as to equity receiverships. *Case* v. *Los Angeles Lumber Products Co.,* 308 U. S. 106. It gives creditors, whether secured or unsecured, the right to exclude stockholders entirely from the reorganization plan when the debtor is insolvent. See *In Re 620 Church Street Bldg. Corp.,* 229 U. S. 24. When the equity owners are excluded and the old creditors be-

come the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority. At that time they stepped into the shoes of the old stockholders. The sale 'did nothing but recognize officially what had before been true in fact.' *Helvering* v. *New Haven & S. L. R. Co.* (C. C. A. 2d), 121 F. (2d) 985, 987."

The *Palm Springs* case which involved a reorganization under the 1932 Revenue Act (which is the same Revenue Act involved in the case at bar) was a companion one to the *Alabama* case and involved basically the same problem, although a different procedure was invoked to salvage the interest of the creditors.

There the Court said:

"The New Corporation acquired the assets directly at the trustee's and the foreclosure sales. The legal procedure employed by the creditors is not material. The critical facts are that the old corporation was insolvent and that its creditors took steps to obtain effective command over its property. For the reasons stated in Helvering v. Alabama Asphaltic Limestone Co., supra, the creditors at that time acquired the equivalent of the proprietary interest of the old equity owner. Accordingly, the continuity of interest test is satisfied" (pages 188, 189 of 315 U. S.).

Recognizing the law to be such, the court below nevertheless in substance held that (1) notwithstanding the fact that by the time the sale occurred the value of the assets in the Old Corporation had sunk so low that there was nothing left for the unsecured creditors or stockholders of the Old Corporation, (2) that the entire equity in the assets was vested solely in the receivers' certificates and

(3) that this condition existed prior to the sale, the holders of the receivers' certificates could not be considered as being a party who had a proprietary interest in the assets of the Old Corporation prior to the sale and retained such interest in the new corporation after the sale. Thus, the Court below said there could not be continuity of interest, and refused to apply the doctrine of the *Alabama* case.

It is the position of Petitioner that when the value of the assets during the pendency of the receivership sunk so low as to leave no equity in the old general creditors and stockholders and the entire equity was in the holders of the receivers' certificates, "the equivalent of the proprietary interest of the old equity owner" (*Palm Springs* case, see above quote) was vested in the holders of the receivers' certificates; and that when these holders bought them in, there was present the requisite continuity of interest within the meaning of the *Alabama* case.

(B) THE DECISION OF THE COURT BELOW IS IN CONFLICT WITH THE DECISION OF THE UNITED STATES COURT OF APPEALS FOR THE 8th CIRCUIT, TO WIT: *MINNEAPOLIS, NORTHFIELD AND SOUTHERN RAILWAY* v. *KLEM,* 117 FED. SUP. 325 (1953) AFFIRMED 225 FED. 2d 909 (8th CIR. 1955).

In the *Minneapolis, Northfield and Southern Railway Company* case the Railway went into a receivership proceeding and during the pendency of the receivership proceeding certain of the substantial creditors sold at a discount their claims to persons who had been strangers to the Old Corporation. These strangers bought in the assets at a sale and used the claims they had bought to pay therefor. The court held in that case that there was continuity of interest even though the purchaser had not been a creditor at the time the insolvency proceedings had com-

menced but rather were persons who had acquired the claims at a discount during the proceedings. It is Petitioner's position that there is no substantial difference between the case at bar and the situation of the taxpayer in the *Minneapolis* case. The District Court in the case at bar differentiated the case at bar from the *Minneapolis* case on the theory that in the *Minneapolis* case the assignee, although it acquired its interest subsequent to the institution of the receivership proceedings, had acquired an interest which had existed at the time the insolvency proceedings commenced; but that petitioner's interest did not exist at the time the receivership proceedings commenced. It is petitioner's position in the case at bar that the reality of the situation was that by permitting the receiver to place a lien on the assets prior in right to those of the general creditors and stockholders, the general creditors and stockholders of the Old Corporation were in effect mortgaging their proprietary interest. It came to pass that the value of the assets declined to a point where there was no equity left in the creditors or stockholders with the result that at the sale of the assets the holders of the receivers' certificates bought in the assets. In effect, the old creditors assigned their claims against the assets to the holders of the receivers' certificates. Surely there can be no real distinction between the two cases because of this. Thus, there is a conflict between the holdings of the Court of Appeals for the 2nd Circuit and the Court of Appeals for the 8th Circuit.

(C) THE HOLDING OF THE COURT BELOW IS IN CONFLICT WITH THE HOLDING OF THIS COURT IN THE CASE OF *NORTHERN P. B. CO.* v. *BOYD*, 228 U. S. 482 (1913). The principle of the *Boyd* case was to the effect that full priority had to be given to each class of interest in a bankruptcy or equity receivership before the next class could be provided for; and even though a

foreclosure proceeding or reorganization or transaction subsequent thereto may take place which leaves any interest in a junior creditor or stockholders to the exclusion of a prior creditor is void or voidable as a matter of law even in the absence of fraud. (See footnote below.*) See also *St. Louis and San Francisco R.R. Co.* v. *Schiller,* 274 U. S.

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* In the *Boyd* case, it was said at pages 560, 561 of 33 Sup. Ct. Rep.:

"Such and similar possibilities at one time caused doubts to be expressed as to whether a court could permit a foreclosure sale which left any interest to the stockholders. But it is now settled that such reorganizations are not necessarily illegal, and, as proceedings to subject the property must usually be in a court where those who ask equity must do equity, such reorganizations may even have an effect more extensive than those made without judicial sale, and bind creditors who do not accept fair terms offered. The enormous value of corporate property often makes it impossible for one, or a score, or a hundred bondholders to purchase, and equally so for stockholders to protect their interests. A combination is necessary to secure a bidder and to prevent a sacrifice. Co-operation being essential, there is no reason why the stockholders should not unite with the bondholders to buy in the property.

"That was done in the present case. And while the agreement contained no provision as to the payment of unsecured creditors, yet the railway company purchased unsecured claims aggregating $14,000,000. Whether they were acquired because of their value, to avoid litigation, or in recognition of the fact that such claims were superior to the rights of stockholders, does not appear, nor is it material. For, if purposely or unintentionally a single creditor was not paid, or provided for in the reorganization, he could assert his superior rights against the subordinate interests of the old stockholders in the property transferred to the new company. They were in the position of insolvent debtors who could not reserve an interest as against creditors. Their original contribution to the capital stock was subject to the payment of debts. The property was a trust fund charged primarily with the payment of corporate liabilities. Any device, whether by private contract or judicial sale under consent decree, whereby stockholders were preferred before the creditor, was invalid. Being bound for the debts, the purchase of their property, by the debts, the purchase of their benefit, put the stockholders in the position of a mortgagor buying at his own sale. If they did so in good faith and in ignorance of Boyd's claim, they were

304; *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106; *Louisville Trust Co.* v. *Louisville, N. A. & C. R. Co.*, 174 U. S. 683. In the case at bar Lee Shubert and J. J. Shubert owned either directly or indirectly 71,680 shares of the Old Corporation stock (34% of the outstanding total); $619,000 principal amount of unsecured debentures (9.7% of the outstanding debentures) and $660,000 of other debt (some secured, some unsecured). They also owned through Atel, 100% of the receivers' certificates which were a lien on all of the free assets of the Corporation prior to the other creditors. In addition to this, the Shuberts personally were at all times the management of the Old Corporation;

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none the less bound to recognize his superior right in the property, when, years later, his contingent claim was liquidated and established. That such a sale would be void, even in the absence of fraud in the decree, appears from the reasoning in Louisville Trust Co. v. Louisville, N. A. & C. R. Co., 174 U. S. 683, 43 L. ed. 1134, 19 Sup. Ct. Rep. 827, where, 'assuming that foreclosure proceedings may be carried on to some extent, at least, in the interests and for the benefit of both mortgagee and mortgagor (that is, bondholder and stockholder),' the court said that 'no such proceedings can be rightfully carried to consummation which recognize and preserve any interest in the stockholders without also recognizing and preserving the interests, not merely of the mortgagee, but of every creditor of the corporation. . . . Any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.'

"6. The railway seeks to distinguish that case from this, insisting that even if the stockholders' participation in the reorganization would have invalidated the proceeding, such result does not follow here because the court having charge of the foreclosure passed on this very question before the sale in 1896 and dismissed the bill of Paton, an unsecured creditor, when he made exactly the same attack upon the reorganization as that by Boyd in this bill. That court then held that as the property was insufficient to pay the mortgage debts of $157,000,000, there was nothing which could come to the unsecured creditors, and they, therefore, had no ground to complain if the bondholders were willing to give new shares to the old stockholders. No appeal was taken from that decision,—possibly because the Paton claim was purchased by

Lee Shubert had been one of the equity receivers up until the very end when he resigned so he could bid in the assets and participate in the reorganization of the assets and the company. Prior to the order being made decreeing the sale of the assets of the Old Corporation, Lee Shubert though his attorney in open court stated that if the reorganization committee could no. work out a plan of reorganization, he would work out himself a plan of reorganization and would "admit all of the creditors of the estate to some kind of participation in a reorganization company." Within a month and five days after the Petitioner acquired

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the railway. But inasmuch as Boyd was not a party to the record, that decree was not binding upon him as *res judicata*, and the opinion, not being controlling authority, cannot be followed in view of the principles declared in Chicago, R. I. & P. R. Co. v. Howard, 7 Wall. 392, 19 L. ed. 117; Louisville Trust Co. v. Louisville, N. A. & C. R. Co., 174 U. S. 674, 43 L. ed., 1130, 19 Sup. Ct. Rep. 827.

"In saying that there was nothing for unsecured creditors, the argument assumes the very fact which the law contemplated was to be tested by adversary proceeding in which it would have been to the interest of the stockholders to interpose every valid defense. If, after a trial, a sale was ordered, they were still interested in making the property bring its value, so as to leave a surplus for themselves as ultimate owners. Even after sale they could have opposed its confirmation if the bids had been chilled, or other reason existed to prevent its approval. In the present case all these tests and safeguards were withdrawn. The stockholders, who, in lawfully protecting themselves, would necessarily have protected unsecured creditors, abandoned the defense that the foreclosure suit had been prematurely brought. The law, of course, did not require them to make or insist upon that defense if it was not meritorious, nor does it condemn the decree solely because it was entered by consent. But the shareholders were not merely quiescent. They, though in effect defendants, became parties to a contract with the creditors, who were in effect complainants, by which, in consideration of stock in the new company, they transferred their shares in the railroad to the railway. The latter then owning the bonds of the complainant and controlling the stock in the defendant, became the representative of both parties in interest. In such a situation there was nothing to litigate, and so the demurrer to the bill was withdrawn. An answer was immedi-

the assets of the Old Corporation, the letter making the offer to the debenture holders, creditors and stockholders of the Old Corporation was made with the resultant exchange of stock. This exchange was reported to the District Court in the receivership proceeding and approved by the court.

(1) Taking all the facts together this exchange must be considered a part of a preconceived plan of reorganization that Mr. Shubert intended to make as above indicated in his statement to the Court prior to the sale that he would admit all creditors to some kind of participation in a reorganization company, or

(2) Petitioner was compelled under the doctrine of the *Boyd* case to admit the old creditors to participate in the petitioner because otherwise it would have been a situation where Lee and J. J. Shubert as stock-

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ately filed, admitting all the allegations of the bill. On the same day, 'no one opposing,' a decree of foreclosure and sale was entered. Two months later the property was sold to the agreed purchaser at the upset price named in the decree. In a few days and by consent that sale was confirmed. As between the parties and the public generally, the sale was valid. As against creditors, it was a mere form. Though the Northern Pacific Railroad was divested of the legal title, the old stockholders were still owners of the same railroad, encumbered by the same debts. The circumlocution did not better their title against Boyd as a nonassenting creditor. They had changed the name, but not the relation. The property in the hands of the former owners, under a new charter, was as much subject to any existing liability as that of a defendant who buys his own property at a tax sale.

"The invalidity of the sale flowed from the character of the reorganization agreement regardless of the value of the property, for in cases like this, the question must be decided according to a fixed principle, not leaving the rights of the creditors to depend upon the balancing of evidence as to whether, on the day of sale, the property was insufficient to pay prior encumbrances."

holders and junior creditors of the Old Corporation would have been participating in the petitioner to the exclusion of other old creditors and stockholders.

A plan of reorganization need not be ready at the time of sale. It can be devised long afterwards. Cf. *Helvering* v. *Southwest Consolidated Corporation,* 315 U. S. 194 (1942) (18 months); see also *Roosevelt Hotel Co.* v. *Commissioner,* 13 T. C. 399 (acquiesced in by the Commissioner) wherein the plan of reorganization was adopted four years after the committee acquired the property, originally for the purposes of liquidation.

As was apparent to this court in the *Boyd* case, if the Shuberts had not had an interest adverse to the general creditors and stockholders in the Old Corporation, they in lawfully protecting themselves would have necessarily protected the others of the same class. However, the opportunity existed by reason of their holding the lien under the receivers' certificates to abandon the interests of others of like kind for the sole protection of themselves. Whether they did so or not is immaterial. The court said in the *Boyd* case of necessity they had to admit all the others of the same class to participate in the reorganized company. Whether this interest represents a proprietary interest or control, certainly the distribution of the stock to them was in recognition of their interest. Whether the interest was given to them to avoid litigation or not, recognition of their superior rights is immaterial according to the *Boyd* case. The court in the instant case in failing to recognize this principle creates a definite conflict between the decision of the court below and the holding of this court in the *Boyd* case. Judge Bicks in his opinion in the District Court which was affirmed in the Court of Appeals, approves the very thing which this Supreme Court condemned.

"The property in the hands of the former owners, under a new charter, was as much subject to any existing liability as that of a defendant who buys his own property at a tax sale.

"The invalidity of the sale flowed from the character of the reorganization agreement regardless of the value of the property, for in cases like this, the question must be decided according to a fixed principle, not leaving the rights of the creditor to depend upon the balancing of evidence as to whether, on the day of sale, the property was insufficient to pay prior encumbrances." (Page 561 of 33 Sup. Ct. Rpt.)

10. There is appended hereto the per curiam opinion of the United States Court of Appeals for the Second Circuit (not reported yet).

Further, the opinion of Judge Bicks in the court of original jurisdiction (145 Fed. Sub. 583) which was printed as part of the appendix in the appeal to the Court of Appeals, is also appended hereto for the convenience of the court.

CONCLUSION

In view of the above, Petitioner respectfully prays that a Writ of Certiorari be granted.

Dated: New York, New York
February 1, 1958

VICTOR R. WOLDER
Attorney for Petitioner
Office and P. O. Address
347 Madison Avenue
Borough of Manhattan
New York 17, New York

APPENDIX

Section 112(i) of the Revenue Act of 1932.

"The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, (C) a recapitalization, or (D) a mere change in identity, form or place of reorganization however effected."

Section 113(a)(7) of the Revenue Act of 1932.

"(7) Transfers to corporation where control remains in the same persons. If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer."

Section 113(a)(7)(A) of the 1939 Internal Revenue Code, as amended.

"Sec. 113—ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS

(a) BASIS (unadjusted) or PROPERTY. The basis of property shall be the cost of such property; except that

* * * * *

(7) TRANSFERS TO CORPORATION—If the property was acquired—

(A) After December 31, 1917, and in a taxable year beginning before January 1, 1936, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, or

* * * * *

(B) In a taxable year beginning after December 31, 1935, by a corporation in connection with a reorganization.

Then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer."

Section 113(a)(12) of the 1939 Internal Revenue Code, as amended.

"BASIS ESTABLISHED BY REVENUE ACT OF 1932—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932, 47 Stat. 199, was prescribed by section 113(a)(6)(7) or (9) of such Act, then for the purposes of this chapter the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932." IRC 113(a)(12).

Section 718(a) of the 1939 Internal Revenue Code, as amended.

"(1) MONEY PAID IN—Money previously paid in for stock, or as paid in surplus, or as a contribution to capital;

(2) PROPERTY PAID IN—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115 (1) for determining earnings and profits;"

Section 760 of the 1939 Internal Revenue Code, as amended.

"Sec. 760 (Internal Revenue Code). (a) DEFINITIONS. For the purpose of this section—

(1) 'EXCHANGE,' 'TRANSFEROR,' and 'TRANSFEREE'—The term 'exchange' means a transaction by which one corporation (hereinafter called 'transferee') receives property of another corporation (hereinafter called 'transferor') and the basis of the property received, in the hands of the transferee, for the purposes of section 718 (a) is determined by reference to the basis in the hands of the transferor.

(2) 'DETERMINATION OF BASIS OF PROPERTY RECEIVED'—The basis, in the hands of the transferee, of the property of the transferor received by the transferee upon the exchange shall be determined in accordance with section 718 (a).

(b) RULE—In the application of section 718(a) to a transferee upon an exchange in determination of the amount paid in for stock of the transferee, or as paid-in surplus or as a contribution to capital of the transferee, in connection with such exchange, only an amount shall be deemed to have been so paid in equal to the excess of the basis in the hands of the transferee of the property of the transferor received by the transferee upon the exchange over the sum of

(1) The amount of any liability of the transferor assumed upon the exchange of any liability subject to which such property was so received, plus

(2) The amount of any liability of the transferee (not arising out of any liability described in paragraph (1) constituting consideration for the property so received, plus

(3) The aggregate of the amount of any money and the fair market value of any other property (other than such stock and other than property described in paragraph (1) and (2) transferred to the transferee.

(c) REDUCTION IN DAILY INVESTED CAPITAL—In the application of section 717 to a transferee upon an exchange, the daily invested capital for any day after such exchange shall be reduced by an amount equal to the amount by which the sum of the amounts specified in paragraphs (1), (2) and (3) of subsection (b) exceeds the basis in the hands of the transferee of the property of the transferor received upon the exchange."

Opinion by Bicks, *D.J.*

#105

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

Civ. 52-331

SELECT THEATRES CORPORATION,

Plaintiff,

—against—

JAMES W. JOHNSON, Collector of Internal Revenue,

Defendant.

Appearances:

VICTOR R. WOLDER,
Attorney for Plaintiff,
347 Madison Avenue,
New York City.

J. EDWARD LUMBARD, United States Attorney for the Southern District of New York,
Attorney for Defendant,
United States Court House,
New York 7, N. Y.

THOMAS C. BURKE,
Assistant U. S. Attorney,
Of Counsel.

BICKS, *D.J.*:

Plaintiff claims to have overpaid income and excess profits taxes for its fiscal year ended June 30, 1943 by $143,069.79 and brings this suit to recover the alleged

overpayment. Its right to prevail turns principally upon

—112—

whether certain of its assets were acquired in a tax-free reorganization.

The Internal Revenue Code of 1939, section 710, imposed a tax on the "adjusted excess profits net income" of corporate taxpayers. Broadly speaking, this was the taxpayer's net income for the year, reduced by a credit deemed to represent the normal or non-excess earnings. Taxpayers were permitted a choice of basis of computing the credit, either on average earnings during the pre-war period 1936 to 1939, or on a return on the amount of capital invested in the enterprise. Plaintiff chose to employ the latter method in determining its tax liability for the tax year under review. It asserts, however, that the credit was computed on what it erroneously conceived to be its "invested capital" with the result that the credit to which it was entitled was grossly understated.

For the fiscal year here involved plaintiff filed a consolidated income and excess profits tax return, covering the operations of itself and its twenty-two wholly-owned subsidiaries[1] which disclosed a liability for taxes in the

—113—

following amounts, all of which were paid:

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[1] Plaintiff, during the taxable year, owned all of the issued and outstanding stock of the following corporations: Select Operating Corporation; Barrymore Theatre Corp.; Century Library, Inc.; Forrest Theatre Company of Phila.; Jayson Building Co. Inc.; Modern Theatre Corporation; 635 Greenwich Street Co., Inc.; 620 W 47 St. Corp.; Stage Costumes, Inc.; Select Lake City Theatre Operating Co.; Acre Realty Co. Inc.; Louisville Amusement & Operating Co.; Opera Under the Stars, Inc.; Sam S. Shubert Amusement Co. Inc.; Walnut & Quince Sts. Corp.; Dee Theatre Corporation; Detroit Downtown Theatre Corporation; Performing Rights Society of the Theatre, Inc.; April Productions Inc.; Continental Music Publishing Co. Inc.; Operatic Festival, Inc.; Ddot Theatre Corporation.

ncome Tax	$ 57,712.73
Declared Value Excess Profits Tax	2,352.74
Excess Profits Tax	132,178.18
	$192,243.65

On December 6, 1946 plaintiff filed a claim for refund of $44,963.42. An amended claim increasing the amount of refund demanded to $142,999.79,[2] was filed on July 16, 1948.

Section 718(a) of the Internal Revenue Code of 1939 provides that the invested capital credit is determined by referring to the property *paid into* the corporation "for stock or as paid-in-surplus, or as a contribution to capital," and including the same "in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange." Under Section 760 of the 1939 Code the basis to the transferee of property *transferred* in a tax-free exchange is determined by reference to the basis of such property in the hands of the transferor or predecessor corporation.[3] Plaintiff paid $400,000. for the assets in question. The basis thereof in the hands of its vendor was upwards of $4,000,000. In the tax return as filed taxpayer treated the

amount it paid for the assets as its invested capital. The claim for refund is predicated on an invested capital in an amount equal to the vendor's basis for said assets.

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[2] The parties have stipulated, and the pre-trial order provides, that the computation of the amount, if any, to be recovered by plaintiff shall await the determination of the legal issues involved.

[3] Internal Revenue Code of 1939, sections 760(a) and 113 (a)(7).

Opinion

Shubert Theatre Corporation (referred to herein as "Shubert") was organized in 1924 for the purpose of taking over the theatrical enterprises which had been conducted for approximately twenty-five years by Messrs. Sam S., Lee and J. J. Shubert. It was one of the principal producers of so-called "legitimate" theatrical attractions in the United States and the largest operator of "legitimate" theatres. The business had been highly profitable and continued so through its fiscal year which ended June 30, 1929. The severe decline in the securities markets in the last quarter of 1929 and the general business depression which followed had a marked adverse effect on the theatrical industry, Shubert included. For the fiscal year ended June 30, 1930, it sustained a net loss of $1,231,000., for the succeeding fiscal year $1,672,000.; and for the period July 1, 1931 to October 20, 1931, $1,187,000.; a loss in the aggregate during this period of approximately twenty-eight months, of $4,090,000. Shubert then found itself unable to discharge its obligations as they matured with the result that on October 20, 1931, a bill of complaint in an equity receivership proceeding was filed in this court by a general creditor. Shubert's answer admitted the allegations of the

—115—

complaint and joined in the prayers for relief contained therein. Irving Trust Company, a New York banking corporation, and Lee Shubert, were thereupon appointed receivers.[4]

At the date the receivership proceedings were instituted Shubert's liabilities consisted of $6,360,000. 6% gold debentures due June 15, 1942; $323,000. accumulated inter-

[4] Subsequent to October 20, 1931, the receivership was extended to include all of Shubert's wholly-owned subsidiaries.

est on said debentures; $1,158,000. notes and accounts payable; Federal amusement taxes payable $9000.; and $284,000. deferred credits.[5] The capital stock consisted of 218,160 shares without par value of which 210,360 were issued and outstanding and 7800 were held in the treasury. Messrs. Lee and J. J. Shubert owned, either directly or indirectly, 71,680 shares of Shubert stock (34% of the total outstanding shares); $619,000. principal amount of Shubert 6% gold debentures (9.7% of the total outstanding debentures); and $660,000. of other debt.

—116—

During the operation of the business by the receivers the liquid assets continued to dwindle. In order to provide funds for payment of the expenses of administration and the continued operation of the business, the receivers were authorized in April 1932 to create a second issue[6] of interest bearing certificates of indebtedness or receiver's certificates in a principal amount not in excess of $400,000. maturing not later than March 1, 1933, and to sell all or any part thereof up to $300,000. in principal amount. The order provided, *inter alia,* that (i) the certificates shall not impose any personal liability on the receivers otherwise than as receivers of Shubert; (ii) the certificates shall be

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[5] Mortgages on real estate totaling $10,749,000. and accrued interest thereon are omitted, it not appearing whether and to what extent, if any, Shubert was liable for deficiencies. Real estate taxes totaling $493,000. likewise are omitted—the City of New York may look for collection only to the property on which the tax liens attach. *Haight* v. *Mayor,* 99 N. Y. 280 (1885); *People ex rel. Meyers* v. *Moynahan,* 130 App. Div. 46 (1st Dept.), 114 N. Y. S. 417 (1909). See *Paddell* v. *City of New York,* 211 U. S. 446 (1908).

[6] A first issue of certificates in the amount of $50,000. was sold during the period October 28, 1931 to February 1, 1932. These certificates were retired, with interest, and are not involved in this case.

secured by (a) a direct charge upon the receivership estate, (b) a lien upon all the assets in the possession of the receivers, subject and subordinate to all valid liens on any part of the assets covered thereby existing at the date of the appointment of the receivers, but prior and superior to the 6% gold debentures due June 15, 1942, and all other unsecured debts, (c) such charge and lien shall rank equally with the charge or lien of all other obligations of the receivers incurred in the operation of the business, except administration expenses, which, by operation of law, may be entitled to priority thereto, (d) such charge or lien shall not, so long as the receiver shall not be in default in the

—117—

payment of said certificates when due, limit or restrict the right of the receivers to dispose of any assets then in their hands or which may thereafter come in their hands in the conduct of the business, or to apply such assets or the proceeds thereof to the payment of expenses and indebtedness incurred by the receivers in the conduct of the business, (e) all the certificates, at the election of the holders thereof, shall become immediately due and payable upon any sale of the assets in satisfaction of any final decree and the termination of the receivership, or in the event that Shubert shall be adjudged bankrupt and (f) the receivers were authorized, by agreement with the holders of the certificates, to extend the maturity date for a period not exceeding three months from March 1, 1933.

The entire issue of said receivers' certificates was sold to The Atel Co., Inc., hereinafter referred to as "Atel." Atel was organized on March 23, 1932 under the Laws of the State of New Jersey. At least from May 1932 all its outstanding stock was owned by Dorsar Enterprises, Inc., a New York corporation, which was 100% owned by the Shuberts individually. The funds employed by Atel for the

purpose of purchasing the receivers' certificates came to it by loan from Dorsar Enterprises, Inc., the latter having previously borrowed a like sum from the Shuberts. Atel

—118—

was neither a stockholder nor creditor of Shubert or any of its subsidiaries.[7]

Efforts in the direction of effecting a reorganization met with no success. The amount of cash and the value of assets readily convertible into cash in the hands of the receivers continued to decline. In the opinion of the receivers further operation of the business might have resulted in further losses. Thus circumstanced, the receivers on January 4, 1933 recommended that the properties and assets in their hands be sold and the proceeds thereof distributed among those entitled thereto. Upon the petition of the receivers a decree was made under date of January 21, 1933, directing that, the assets be sold, either in bulk or in separate parcels, to the highest bidder or bidders (in case of a bulk sale an upset price of $400,000. was fixed); any creditor or any stockholder, director or officer of Shubert may purchase the assets in his own right, and Lee Shubert, one of the receivers, may likewise bid at such sale, or may be interested in any corporation that shall bid thereat and he or any such corporation may purchase the assets in his or in its own right provided that he shall have resigned as receiver prior to the date of the sale; and further, that

> "no sale of the * * * assets * * * shall be confirmed to any purchaser on behalf of, or for the benefit of,

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[7] It does not appear from the record whether Dorsar Enterprises, Inc. was a stockholder or creditor of Shubert or any of its subsidiaries.

—119—

any corporation organized or to be organized with the intention that it shall become the owner of said * * * assets * * * pursuant to any plan or agreement of reorganization unless at or before the sale * * * such purchaser shall have filed with the Special Master a complete copy of such plan or arrangement * * * and no sale of any property * * * to any purchaser who is to purchase such property pursuant to any such plan or agreement shall be confirmed if the Court shall determine that the provisions of such plan * * * are inequitable * * *. So much of the purchase price as may not be required by the Court to be paid in cash may be paid in whole or in part by delivery to the Special Master, * * * outstanding Receivers' Certificates of Indebtedness and/or claims allowed * * *, including claims in respect of the 6% Gold Debentures * * *. The purchaser shall be credited on account of the purchase price with such sum * * * as would be payable in cash, out of the proceeds of the sale, in respect of said Receivers' Certificates of Indebtedness. Debentures, * * * and other claims, if the whole amount of the purchase price were paid in cash."

Lee Shubert removed any disqualification to become a bidder at the sale or interested in the purchaser by resigning as receiver. The sale pursuant to said decree originally scheduled for February 24, 1933 was adjourned from time to time to April 7, 1933. As a condition to the last adjournment Lee Shubert bound himself to bid or cause to be bid not less than $400,000. for the assets held in the receivership estate. At the sale the assets were struck down in bulk to the only bidder—Select Theatres Corporation, the plaintiff herein, for $400,000. Upon the Special

Master's report of sale and petition of the plaintiff herein a decree was entered confirming the sale. The petition recited that plaintiff intended to deliver the receivers'

—120—

certificates to the Special Master on account of the purchase price and prayed that the Special Master be directed to credit on account of the purchase price such sums as would be payable out of the proceeds of sale in respect of said receivers' certificates if the whole amount of the purchase price were paid in cash. The confirmatory decree authorized the Special Master to accept said certificates as pro tanto payment of the purchase price. It recited further

> "it appearing to the Court that said Select Theatres Corporation has not been organized with the intention that it shall become the owner of the properties and assets of defendants, or any part thereof, or any beneficial interest therein, pursuant to any plan or agreement of reorganization, and does not propose to purchase said properties and assets, or any part thereof, on behalf of, or for the benefit of, any other corporation organized or to be organized with such intention."

Select Theatres Corporation, the successful bidder, was organized on April 5, 1933, two days before the sale. Its original authorized capital stock consisted of 200 shares of common stock without par value. At its first meeting the Board of Directors accepted an offer by Atel to purchase 101 shares of its common stock for $404,000. to be paid, $300,000. by delivery of the receivers' certificates and the balance, less accrued interest on said certificates in cash. On April 17, 1933, the subscription agreement was

modified. Under the amended agreement Atel subscribed to 140 shares for $14,000. and agreed to loan to the com-

—121—

pany $390,000. (in cash and the aforesaid receivers' certificates) against its one year note.

The purchase at the Special Masters sale was consummated on April 25, 1933. Payment of the purchase price was made by delivery of the receivers' certificates duly endorsed, plus $90,009.52 in cash[8] representing the difference between the principal amount of the receivers' certificates plus accrued interest and the $400,000. purchase price. The cash proceeds of the sale were applied to the payment of expenses of administration by the estate in receivership after which no amount whatever remained available for distribution among the creditors or stockholders of Shubert.

On or about May 31, 1933 Lee Shubert addressed a communication to the creditors and stockholders of Shubert, stating in part:

> "When the Court decided that the assets of the Corporation were to be sold at public auction, we offered the security holders a plan of reorganization, but the subscriptions were insufficient to carry it through. Consequently, the assets were purchased by Select Theatres Corporation (in which I have a substantial interest) for the upset price fixed by the Court—$400,000. No other bidder appeared at the sale. The sale was confirmed by the Court, and the transfer of the assets has been substantially completed.

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[8] This cash was obtained in the same manner as the cash originally employed to purchase the receiver's certificates, i.e., the Shubert partnership advanced the same to Dorsar Enterprises, Inc., which in turn advanced the funds to Atel, and the latter supplied them to plaintiff.

"Select Theatres Corporation will be recapitalized with an authorized capital to consist of $400,000 of

—122—

6% non-cumulative preferred stock, which may be issued up to the full amount of the price paid for the properties ($400,000), and 200,000 shares of common stock, with a nominal par value, both classes of stock being entitled to one vote per share.

"The stockholders of Shubert Theatre Corporation will, of course, receive nothing as a result of the sale of the Corporation's assets. Debentureholders and other creditors are entitled to their pro rata share of the purchase price after payment of expenses and Receiver's obligations; but it now appears likely that very little, if anything, will be available for distribution to debenture holders and other creditors when the receivership is finally wound up.

"Nevertheless, it is my earnest desire that those who invested their money in Shubert Theatre Corporation, under my management, shall have an opportunity to participate in the new company, and to benefit with the return of prosperity, if such time arrives. Accordingly, I have arranged for the issuance of 50% of the common stock of Select Theatres Corporation to security holders and creditors of Shubert Theatre Corporation, without cost to them.

"This stock, the greater portion of which would otherwise become part of my personal holdings, will be distributed on the following bases:

10 shares of common stock of Select Theatres Corporation in respect of each $1,000 debenture (with June 15, 1931, and subsequent coupons attached) of Shubert Theatre Corporation;

1 share of common stock of Select Theatres Corporation in respect of each $105 of allowed claims against Shubert Theatre Corporation;

1 share of common stock of Select Theatres Corporation in respect of each 10 shares of common stock of Shubert Theatre Corporation.

—123—

* * * * *

"Security holders and creditors of Shubert Theatre Corporation availing themselves of this offer should forward their securities or allowed claims to me in care * * * I will not take title to the securities and claims so forwarded but, acting as agent for the holders thereof, will surrender them to Shubert Theatre Corporation for cancellation. No transfer stamps or other expenses will be payable by those who take advantage of this offer. The debentures and allowed claims will not be canceled until it is definitely known whether or not there will be anything available for distribution to the holders thereof. If anything should be available, I will collect the amount due upon the debentures and allowed claims surrendered by those who have accepted my offer, and will turn over to them the amounts which they are respectively entitled to, less expenses incurred by me in that connection."

To permit of issuance of the stock in accordance with said letter plaintiff caused its authorized capitalization to be modified to consist of 40,000 shares of 6% non-cumulative preferred stock par value $10.00 per share, and 200,000 shares common stock par value 10 cents per share. The 140 shares of common stock no par value, previously authorized to be issued, were exchanged for 1400 shares of preferred

stock. Atel's subscription agreement as previously amended was further modified. Instead of loaning plaintiff $390,000., Atel subscribed to 36,650 shares of preferred stock and 200,000 shares of common stock and agreed to pay therefor $366,500. and $20,000. respectively. 100,000 shares of said common stock were set aside for distribution to the debenture holders, general creditors and stockholders of

—124—

Shubert in accordance with the offer contained in Lee Shubert's letter. Of the shares of common stock thus set aside an aggregate of 79,731 shares were ultimately distributed among the holders of $5,472,000 principal amount of the 6% debentures (over 86% of the total amount outstanding); the holders of $692,963.20 face amount of general claims (over 63% of the total claims allowed in the receivership); and the holders of 175,361 shares of the capital stock of Shubert (over 82% of the number of shares outstanding), in the amounts and proportions set out in the aforementioned letter. The remaining 20,629 shares of common stock were ultimately issued to Atel. It would appear, therefore, that the cost to Atel of 38,050 shares of preferred stock and 120,269 shares of common stock, was $400,500. Ascribing to the preferred stock its par value, approximately 60% of the common stock of plaintiff cost Atel $20,000.

In response to an inquiry from a Shubert stockholder who had accepted the offer set forth in Lee Shubert's letter, plaintiff's treasurer under date of March 31, 1936, advised him that the shares of Select Theatres Corporation he received was purely a gratuitous offer by Lee Shubert, the stock did not originate from Shubert Theatre Corporation, the stock was not offered under any plan of reorganization and that the offer of stock was made subsequent

—125—

to the sale of the assets. The letter in full, is set forth in the margin.[9]

Plaintiff's origin and background have been developed at length because of the claim that, with these credentials plaintiff may gain entry into the golden circle of corporate legatees. The conclusion is inevitable, however, that its ancestor, Shubert, was put to death on the auction block under circumstances that plaintiff may not collect its claimed inheritance—a "basis windfall" giving it a basis for its assets far above the market value thereof at the time of acquisition and upwards of ten times the amount it paid for them.

Plaintiff does not, and indeed cannot, urge that the gratuitous distribution of a portion of its voting securities to former creditors and stockholders of Shubert was in pursuance of or constituted a plan of agreement of reorganization. Its claim in essence is that plaintiff's ownership of the receivers' certificates, the order authorizing the Spe-

—126—

cial Master to accept, and his acceptance of, the receivers' certificates as payment on account of the purchase price in lieu of cash, constituted a tax-free reorganization under Section 112 of the Revenue Act of 1932.

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[9] "Your letter of March 27, 1936, addressed to Mr. Lee Shubert has been referred to me for attention. As former comptroller of the Shubert Theatre Corporation and as present Treasurer of the Select Theatres Corporation, I am in a position to give you the information requested.

"Your understanding that the ten shares of Select Theatres Corporation which you received, was purely a gratuitous offer by Mr. Lee Shubert, is correct. The stock did not originate from the Shubert Theatre Corporation nor was it offered to you under any plan of reorganization. The assets of the Shubert Theatre Corporation were sold in the receivership proceedings and were entirely insufficient to meet its debts and such sale did occur prior to the offer of the ten shares of stock."

This contention is challenged by the defendant. It urges that the ownership of the receivers' certificates did not confer upon plaintiff an "equity" in Shubert and that there is lacking the "continuity of interest" necessary to support a tax-free reorganization.

The 1932 Act, Section 112(j), defines a reorganization, insofar as here material, thusly:

> "The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of * * * substantially all the properties of another corporation) * * * "

Whether a transaction qualifies as a reorganization under the Revenue Act does not turn alone upon a compliance with the literal language of the statute. *Commissioner of Internal Revenue* v. *Gilmore's Estate,* 130 F. 2d 791 (3d Cir. 1942). The words of the statute within the parenthesis expand the meaning of "merger" or "consolidation" so as to include some transactions which partake of the nature of a merger or consolidation but are beyond the ordinary and commonly accepted meaning of those words—so as to embrace circumstances difficult to delimit but which in strictness cannot be designated as either merger or consolidation. *Pinellas Ice & Cold Storage Co.* v. *Commissioner,* 287 U. S. 462, 470 (1933). In the *Pinellas* case the

transfer of assets from one corporation to another for well secured short-term notes like the purchase for money of the assets of one company by another, was held to have no real resemblance to a merger or consolidation and beyond the evident purpose of the statute. It was subsequently held that the term of the obligation, whether long-term bonds or short-term notes is not material. *LeTulle* v. *Scofield,*

308 U. S. 415 (1940). Unless the transferor retains a definite and substantial proprietary interest in the enterprise,[10] the transfer does not amount to a reorganization within the true meaning of the statute, but is a sale upon which gain or loss must be reckoned. *Pinellas Ice & Cold Storage Co.* v. *Commissioner, supra; Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378 (1935); *LeTulle* v. *Scofield, supra.*

The problem of "continuity of interest" was considered by the Courts principally from the single aspect of what the old proprietors must receive in the new enterprise. But with the profusion of distress reorganizations engendered by the economic depression of the early 1930's it became necessary to explore another element of the problem, to wit, who are the old proprietors. The latter problem is the crucial one here.

—128—

The problem of the identity of the old proprietors was first presented to the Supreme Court in a group of cases decided in 1942. *Helvering* v. *Alabama Asphaltic Limestone Company,* 315 U. S. 179; *Palm Springs Holding Corporation* v. *Commissioner,* 315 U. S. 185; *Bondholders Committee etc.* v. *Commissioner,* 315 U. S. 189; *Helvering* v. *Southwest Consolidated Corporation,* 315 U. S. 194. The first two of said cases are the significant ones here.

In the *Alabama* case the respondent acquired all the assets of an insolvent corporation pursuant to a creditors plan of reorganization consummated with the aid of the bankruptcy court. At the sale by the bankruptcy trustee

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[10] Receipt of preferred stock of the transferee corporation by the stockholders of the selling corporation has been held to represent a substantial continuation of their interest. *John A. Nelson Co.* v. *Helvering,* 296 U. S. 374 (1935).

the creditors committee was the successful bidder. The price was paid in substantial part by agreements of creditors to accept stock of a new corporation in full discharge of their claims and by an offer of the committee to meet the various costs of administration. Pursuant to the plan all the stock of the respondent was distributed among the creditors of the bankrupt company. The Government contended that the requisite continuity of interest was broken because the stockholders of the bankrupt corporation were eliminated by the plan (no portion whatever of their proprietary interest having been preserved for them in the new corporation) and hence there was "no reorganization." Recognizing that the old continuity of interest had been

—129—

broken, the Court held that it was

> "immaterial that the bankruptcy sale shifted the ownership of the equity in the property from the stockholders to the creditors of the old corporation. Plainly, the old continuity of interest was broken. Technically that did not occur * * * until the judicial sale took place. For practical purposes, however, it took place not later than the time when the creditors took steps to enforce their demands against their insolvent debtor. In this case, that was the date of the institution of bankruptcy proceedings. From that time on they had effective command over the disposition of the property. The full priority rule of *Northern P. B. Co.* v. *Boyd,* 228 U. S. 482, applies to proceedings in bankruptcy as well as to equity receiverships. *Case* v. *Los Angeles Lumber Products Co.,* 308 U. S. 106. It gives creditors, whether secured or unsecured, the right to exclude stockholders entirely from the reorganization plan when the debtor is insolvent. See *In*

Re 620 Church Street Bldg. Corp., 229 U. S. 24. When the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority. At that time they stepped into the shoes of the old stockholders. The sale 'did nothing but recognize officially what had before been true in fact.' *Helvering* v. *New Haven & S. L. R. Co.* (CCA 2d), 121 F. (2d) 985, 987."

The *Palm Springs* case was a companion one to the *Alabama* case and involved basically the same problem, although a different procedure was invoked to salvage the interest of the creditors. The decision in the *Alabama* case was held to be controlling. "The critical facts" held the Court "are that the old corporation was insolvent and that its creditors took effective steps to obtain command over its property. For the reasons stated in *Helvering* v.

—130—

Alabama Asphaltic Limestone Co., supra, the creditors at that time acquired the equivalent of the proprietary interest of the old equity owner. Accordingly, the continuity of interest test is satisfied."

In the *Alabama* and *Palm Springs* cases, and those which followed them,[11] there arrived some point in time when it could be said that ownership of the corporation shifted

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[11] See, e.g., *Templeton's Jewelers, Inc.* v. *United States,* 126 F. 2d 251 (6th Cir., 1942); *Rotenberg* v. *Sheehan,* 48 F. Supp. 584 (E. D. Mo., 1943), appeal dismd., 144 F. 2d 992 (8th Cir. 1944); *Braicks* v. *Hendricksen,* 43 F. Supp. 254 (W. D. Wash., 1942), aff'd 137 F. 2d 632 (9th Cir. 1943); *Connohio, Inc.,* 9 T. C. M. 1105, 1950; *Peabody Hotel Company,* 7 T. C. 600 (1946). See also *Helvering* v. *Cement Investors, Inc.,* 316 U. S. 527 (1942).

to the creditors. Typically, the change of ownership takes the form of an assumption of control by a creditors committee, or by an indenture trustee acting for the benefit of bondholders after the formulation of a reorganization plan. The exercise by the creditors of their rights of priority, and of their right to take over the corporate assets to the exclusion of the stockholders, works a transfer of dominion which puts them in the place of the stockholders. When, following the bankruptcy or receiver's sale, the creditors take over the assets of the corporation and become the stockholders of the new corporation, they are merely continuing an equity relationship which had by then already existed.

—131—

This rationale is consistent with the concept reflected on a corporate balance sheet and stems from the relationship between a corporation and its creditors. On one side of the balance sheet there is set forth the assets of the corporation and on the other, first the interests of the creditors—the liabilities, and then those of the equity owners—whatever remains after deducting the liabilities from the assets. This balance is the capital of the corporation. Those who deal with the corporation look to its capital funds as a source of and security for payment of the debts due them. If insolvency intervenes and the creditors take effective steps to enforce their demand via a foreclosure or bankruptcy or reorganization proceeding they step into the shoes of the stockholders *vis a vis* the interests or equity of the latter in the totality of rights and assets of the company.

No case has been cited by counsel and independent research by the Court has failed to find one dealing with the

status of a holder of receiver's certificates as a party to a reorganization. The dissimilarity between the origin and rights of the certificate holder and those of the corporate creditor make apparent that the reasons for relating creditors to stockholders are absent in the case of the former. The certificate holder did not deal with Shubert as such. The loan which is evidenced by the certificates was made to the receivers and not to Shubert. The rights

—132—

of the certificate holder did not derive from Shubert and the ownership thereof carried with it no right to take any action against Shubert in the event the certificates remained unpaid. The receivers' certificates were not absolute promises to pay nor debts of Shubert. They were debts of the receivers in their official capacity backed by the pledged faith of the Court that the proceeds of the property on which they were a charge, to the extent they were sufficient for that purpose, would be applied to their payment. See Clark, Receivers §§459, 461 (2d ed. 1929).

Until the sale the receivers were, both in fact and in legal contemplation, attempting to rehabilitate Shubert for the benefit of its creditors existing at the time of the institution of the proceeding. In view of its insolvency only the creditors held the equity in Shubert during the receivership. Nor does the fact that the certificates were secured by a charge or a "lien" on the property of Shubert in the hands of the receivers add weight to the suggestion that the certificate holder possessed or exercised a proprietary interest. It was not such a lien as conferred powers of foreclosure or control. To say that the holders had a "lien" is to say only that they had a right to repayment out of whatever assets were available for that pur-

pose prior to the unsecured creditors of Shubert. Until there is a default, a creditor's interest is not the equivalent of a proprietary interest notwithstanding that upon default the creditor may also enforce a lien upon specific property. True, insolvency of the debtor operates as an anticipatory breach of an executory agreement (*Rohem* v. *Horst,* 178 U. S. 1 (1900); *Central Trust Co.* v. *Chicago Auditorium Association,* 240 U. S. 581 (1916)) but here the certificate holder well knew it was making a loan to an insolvent estate in receivership. No term may be implied therefore, that the borrower would not permit itself through insolvency to become disabled from meeting its engagement. Absent such term, expressed or implied, the doctrine of anticipatory breach may not be invoked. Here the receivers' certificates were not due when the Special Master's sale was scheduled to be held. As already indicated Lee Shubert individually committed himself to bid an amount sufficient to discharge in full the receivers' certificates with interest—an undertaking which the certificate holder was content to accept. Under the circumstances its interests could in no wise be affected by Shubert's insolvency.[12] Payment in full when due with interest having been satisfactorily provided for, the rights of the certificate holder were akin to those of a creditor of a solvent debtor. The best that can be urged (without intimating, however, that such a contention is sound) is that the certificate holder had a mere possibility of a proprietary interest but that, as the Court said in the

[12] "A plan does not 'affect' the claims of creditors when they retain exactly what they had before." *Gross* v. *Bush Terminal Co.,* 105 F. 2d 930, 932 (2d Cir., 1939).

Alabama case, "is, of course, not its equivalent." Taking full account of the steps involved in the issuance of the certificates, the rights which they conferred and the use to which they were put to acquire the Shubert assets, there was no point in time prior to the receiver's sale when it can be said that plaintiff, as the holder of the certificates, had the right to or took effective command of the Shubert assets.

Plaintiff's brief argues that there is "no substantial difference whatever" between the instant case and *Minneapolis, Northfield & Southern Railway* v. *Klem,* 117 F. Supp. 325 (D. Minn. 1953), aff'd 225 F. 2d 909 (8th Cir. 1955). In that case, a sufficient continuity of interest was found to exist despite changes in the ownership of creditors' claims during the pendency of the proceeding. As assignees, the new holders of the claims were held to be clothed with the same creditors rights and powers as had inured to their assignors. The new holders of the claims which antedated the commencement of the proceeding, were not divested of their right to reorganize the company merely because they became owners during the pendency of the proceeding. The *Minneapolis* case is similar to the case at bar in that the assignees of the creditors' claims, like the holder of the receivers' certificates, acquired their respective rights after the institution of the proceedings. Here, however, the similarity ends. In the case at bar, with respect to plaintiff's assignor—the original holder of the receivers' certificates—continuity of interest was lacking; in *Minneapolis* with respect to the assignors—creditors whose claims arose out of dealings with the corpora-

tion prior to the institution of the proceeding—continuity of interest existed.

The facts are, of course, that as matters eventuated, there were no bidders at the Special Master's sale for the assets in separate parcels, they were struck down in bulk, the successful bidder was the holder of the receivers' certificates, the same were applied on account of the purchase price, and the purchaser has continued the business enterprise. The circumstance that at or about the time of the sale plaintiff acquired the receivers' certificates and obtained permission to apply them on account of the purchase price did not alter its status as a cash purchaser nor confer benefits upon it different than those that would inure to any cash purchaser. Indeed, its bid was for a fixed sum payable in cash and but for its application for leave to pay part of the purchase price by surrendering the certificates, they would have been fully discharged by payment in cash.

Before the Special Master's sale the certificate holder had no rights to the ownership of the assets in the hands of the receiver. Whatever rights of ownership it ultimately acquired stemmed from, and did not pre-date, the sale. The continuity of interest, therefore, was broken and no reorganization occurred.

—136—

This leaves for consideration plaintiff's alternate position that if it is not entitled to include in its equity invested capital Shubert's basis of the assets it purchased at the Special Master's sale, it is entitled to include the basis of the stock, debentures and unsecured claims of Shubert in the hands of those who accepted the offer contained in the Lee Shubert letter discussed *supra*. Reliance for this alternate position is placed on §113(a)(8)(B) of the In-

ternal Revenue Code.[13] This position is clearly untenable: (1) Plaintiff acquired no property from the old stockholders and creditors who accepted Lee Shubert's offer. The offer was wholly gratuitous, was made by Lee Shubert individually, not by the plaintiff, and was made after the acquisition of the assets. Under the terms of the letter those who accepted the offer transferred no property to anybody, certainly not to the plaintiff. "Security holders and creditors of Shubert Theatre Corporation," wrote Lee Shubert "availing themselves of the offer should forward their certificates or allowed claims to *me* * * * . *I* will not

—137—

take title to the securities so forwarded, but, acting as agent for the *holders* thereof, will surrender them to Shubert Theatre Corporation for cancellation." If any contribution was made by the old stockholders and creditors —and none could have been made since after the sale the old stock and the claims of creditors were valueless—it was made to Lee Shubert, not to the plaintiff. But there was no intention to pay in surplus or make a contribution to the capital of either Shubert or plaintiff—witness the following from Lee Shubert's letter "The debentures and allowed claims wil not be canceled until it is definitely

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[13] "Sec. 113 * * * (a) BASIS (UNADJUSTED) OF PROPERTY.—The basis of property shall be the cost of such property; except that—

(8) PROPERTY ACQUIRED BY ISSUANCE OF STOCK OR AS PAID-IN-SURPLUS.—If the property was acquired after December 31, 1920, by a corporation—* * *

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made."

known whether or not there will be anything available for distribution to the holders thereof. If anything should be available, I will collect the amount due upon the debentures and allowed claims surrendered by those who have accepted my offer, and will turn over to them the amounts which they are respectively entitled to, less expenses incurred by me in that connection," and his earlier statements in said letter "I have arranged for the issuance of common stock of Select Theatres Corporation to security holders and creditors of Shubert Theatre Corporation, without cost to them. This stock * * * would otherwise become part of my personal holdings. * * * " (2) Plaintiff did not issue any stock to the old stockholders and creditors who accepted Lee Shubert's offer. The stock which was delivered to them had been subscribed to and fully paid for by Atel which was entitled to have the same issued to it

—138—

or its nominees. In delivering the stock, it was acting pursuant to the instructions of and as agent for Atel. The delivered stock was stock *of* the plaintiff, but not *its* stock. The facts here are wholly without the provisions of section 113.

Plaintiff suggests that Lee Shubert's offer to distribute stock which otherwise would be part of his personal holdings was not wholly gratuitous, but was made to avert possible claims of creditors under the "absolute priority" rule of *Northern Pacific R. Co.* v. *Boyd,* 228 U. S. 482 (1913). Assuming, without deciding the question, that the offer was prompted by such a motive, it still does not follow that an after-thought may rise to the dignity of a pre-conceived plan of reorganization or justify invoking section 113 of the Internal Revenue Code. An attempt to

forestall claims and to provide insulation to the stockholders of the new corporation from suit by giving the Shubert creditors a minor interest in the new corporation is not tantamount either to a reorganization or the acquisition of property by the new corporation by issuance of stock or as paid in surplus or as a contribution to capital. The requisite continuity of interest must flow from rights recognized in a plan, otherwise the continuity is broken. Its existence must be determined by reference to facts as they occurred and not legal rights which might have been, but were not, asserted. (Cf. *Templeton's Jewelers, Inc.* v. *United States,* note (11) *supra.*)

—139—

Plaintiff acquired the Shubert assets by purchase and not in furtherance of a tax-free reorganization. The basis it ascribed thereto in its tax return as filed was correct and the claim for refund is denied.

The foregoing shall constitute Findings of Fact and Conclusions of Law in accordance with Fed. R. Civ. P. 52(a). Dated: September 29, 1956.

ALEXANDER BICKS
United States District Judge.

10/1/56
Judgment Entered

HERBERT A. CHARLSON
Clerk

10/22/56—Costs taxed on the sum of $20.00.

HERBERT A. CHARLSON
Clerk

Per Curiam Opinion of the U. S. Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 19—October Term, 1957.

(Argued November 12, 1957 Decided December 3, 1957.)

Docket No. 24447

SELECT THEATRES CORPORATION,

Plaintiff-Appellant,

—v.—

JAMES W. JOHNSON, Collector of Internal Revenue,

Defendant-Appellee.

Before:

CLARK, *Chief Judge,*
MOORE, *Circuit Judge,* and LEIBELL, *District Judge.*

Appeal from the United States District Court for the Southern District of New York, Alexander Bicks, *Judge.*

Plaintiff, Select Theatres Corporation, appeals from a judgment in favor of defendant, James W. Johnson, Collector of Internal Revenue, in an action for the recovery of federal income and excess profits taxes paid by plaintiff. Affirmed.

Per Curiam Opinion of the U. S. Court of Appeals

VICTOR R. WOLDER, New York City, *for plaintiff-appellant.*

MORTON S. ROBSON, Asst. U. S. Atty., S. D. N. Y., New York City (Paul W. Williams, U. S. Atty., New York City, on the brief), *for defendant-appellee.*

PER CURIAM:

Judgment affirmed on the opinion of District Judge Bicks, D. C. S. D. N. Y., 145 F. Supp. 583.

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No. 781

In the Supreme Court of the United States

October Term, 1957

SELECT THEATRES CORPORATION, PETITIONER

v.

JAMES W. JOHNSON, Collector of Internal Revenue

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

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INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	4
Argument	9
Conclusion	14

CITATIONS

Cases:

Bondholders Committee v. *Commissioner*, 315 U.S. 189	11
Helvering v. *Limestone Co.*, 315 U.S. 179	10, 11, 13, 14
Helvering v. *Minnesota Tea Co.*, 296 U.S. 378	10
LeTulle v. *Scofield*, 308 U.S. 415	10
Minneapolis, N. & S. Ry. v. *Kelm*, 117 F. Supp. 325, affirmed, 225 F. 2d 909	13
Northern Pacific Ry. v. *Boyd*, 228 U.S. 482	13, 14
Palm Springs Corp. v. *Commissioner*, 315 U.S. 185	10, 11
Pinellas Ice Co. v. *Commissioner*, 287 U.S. 462	10

Statutes:

Internal Revenue Code of 1939:	
Sec. 113(a) (26 U.S.C. 1952 ed., Sec. 113 (a))	4, 9
Sec. 718(a) (26 U.S.C. 1952 ed., Sec. 718 (a))	4, 9
Revenue Act of 1932, c. 209, 47 Stat. 169:	
Sec. 112(a)	2
Sec. 112(b)	2, 9, 10
Sec. 112(i)	2, 9
Sec. 113(a)	3, 9

In the Supreme Court of the United States

October Term, 1957

No. 781

SELECT THEATRES CORPORATION, PETITIONER

v.

JAMES W. JOHNSON, Collector of Internal Revenue

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (Pet. 30-55), is reported at 145 F. Supp. 583. The opinion of the Court of Appeals (Pet. 56-57) is reported at 249 F. 2d 655.

JURISDICTION

The judgment of the Court of Appeals was entered on December 3, 1957. (Pet. 56-57.) Taxpayer's petition for a writ of certiorari was filed on February 11, 1958. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether, as both courts below held, taxpayer did not acquire its assets pursuant to a tax-free reorganization under Section 112(b)(4) and (i) of the Revenue Act of 1932, and hence was required to use the cost to it rather than a substituted basis for the assets in computing its equity invested capital for excess profits tax purposes.

STATUTES INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * *

(4) *Same — Gain of Corporation.* — No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

* * * *

(i) *Definition of Reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least

a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

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SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * *

(7) *Transfers to corporation where control of property remains in same persons.*—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. * * *

* * * *

Internal Revenue Code of 1939:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * *

(12) *Basis established by Revenue Act of 1932.*—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932, 47 Stat. 199, was prescribed by section 113(a)(6), (7), or (9) of such Act, then for the purposes of this chapter the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

* * * *

(26 U.S.C. 1952 ed., Sec. 113.)

SEC. 718 [As added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * * *

(2) *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for

determining loss upon sale or exchange.
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(26 U.S.C. 1952 ed., Sec. 718.)

STATEMENT

The material facts, as found by the District Court (Pet. 30-43), may be summarized as follows:

In 1924 Shubert Theatre Corporation (hereafter called Shubert) was organized to take over theatrical enterprises theretofore conducted by Messrs. Sam S., Lee, and J. J. Shubert. With the onset of the depression in 1929, Shubert sustained increasing losses and on October 20, 1931, equity receivership proceedings were instituted, Lee Shubert being appointed one of the receivers. As of October 20, 1931, Shubert's liabilities consisted of $6,360,000 6% gold debentures due June 15, 1942, plus accumulated interest thereon of $323,000; $1,158,000 in notes and accounts payable; and $293,000 in other items. There were also real estate mortgages exceeding $10,000,000, and substantial arrearages in real estate taxes. Messrs. Lee and J. J. Shubert owned, directly or indirectly, 34% of Shubert's outstanding stock, 9.7% of the outstanding debentures, and in excess of 40% of the remaining indebtedness (other than real estate mortgages and taxes). (Pet. 33-34.)

In April, 1932, in order to provide funds for payment of administration and operating expenses, the receivers pursuant to court order issued $300,000 of receiver's certificates, maturing not later than March 1, 1933.[1] The authorizing order provided, among other

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[1] The receivers were authorized, by agreement with the holders of the certificates, to extend the maturity date for

things, that the certificates should be secured by a lien upon all assets in the receivers' possession, prior and superior to the gold debentures and unsecured debts, but subordinate to valid liens existing at the date of the receivers' appointment and to administration expenses; that the certificates should not (unless defaulted when due) limit the right of the receivers to dispose of any assets in their hands and apply the proceeds to payment of administration expenses; that the certificates, at the election of the holders, should become due and payable upon any sale of assets and termination of the receivership, or in the event Shubert should be adjudged bankrupt. (Pet. 34-35, 39.)

The entire issue of certificates was sold to the Atel Company, Inc., a newly organized corporation wholly-owned by Dorsar Enterprises, Inc., which in turn was wholly-owned by the Shuberts individually. The money Atel used to purchase the certificates was a loan from the Shuberts to Dorsar to Atel. (Pet. 35-36.)

Efforts to effect a reorganization were unsuccessful, and Shubert's assets continued to dwindle. Hence, on January 21, 1933, a decree was entered in the receivership proceedings directing that Shubert's assets be sold to the highest bidder, with an upset price of $400,000 fixed for bulk sale. It was provided that any creditor, stockholder, or officer of Shubert might bid in his own right, including Lee Shubert if he resigned as receiver prior to the sale. It was fur-

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a period not exceeding three months from March 1, 1933. (Pet. 35.)

ther provided that no sale should be confirmed to any purchaser for a corporation organized to become the owner of the assets pursuant to a plan of reorganization, unless such plan was theretofore approved by the court. And finally, it was provided that part of the purchase price might be paid by delivery of receivers' certificates or other claims. (Pet. 36-37.)

Lee Shubert thereafter resigned as a receiver, and secured a postponement of the sale to April 7, 1933, by undertaking to bid, or cause to be bid, not less than $400,000 for the assets. On April 5, 1933, Select Theatres Corporation, the taxpayer herein, was organized as a subsidiary of Atel, and acquired the receivers' certificates from Atel in the form of a loan. Two days later, on April 7, the sale was held and the assets were struck down to taxpayer, the only bidder, for $400,000. The confirmatory decree authorized the Special Master to accept the receivers' certificates from taxpayer as *pro tanto* payment of the purchase price, and noted further that taxpayer had not been organized to become owner of the Shubert assets pursuant to any plan or agreement of reorganization. Thereafter, the sale was consummated by delivery of the receivers' certificates duly endorsed, plus $90,009.52 in cash (a loan from the Shubert partnership to Dorsar to Atel to taxpayer) representing the difference between the purchase price and the principal amount of the receivers' certificates plus accrued interest. The cash proceeds of the sale were applied to the payment of administration expenses, after which nothing remained for distribution to the creditors or stockholders of Shubert. (Pet. 37-39.)

On May 31, 1933, Lee Shubert wrote a letter to Shubert's creditors and stockholders. Noting that a plan of reorganization had fallen through prior to the sale of Shubert assets to taxpayer, and that Shubert's creditors would receive little or nothing out of the proceeds of the sale, he expressed his earnest desire that those who invested their money in Shubert should have an opportunity to participate in the new company. Hence, he stated, he had arranged for issuance of 50% of the common stock of taxpayer (after a described recapitalization) to security holders and creditors of Shubert, without cost to them. This stock, the greater part of which would otherwise have become part of Lee Shubert's personal holdings, was to be distributed, in prescribed ratios, in exchange for debentures, allowed claims, and stock of Shubert. (Pet. 39-41.)

In response to Mr. Shubert's offer, over 86% of Shubert's debentures, over 63% of its allowed claims, and over 82% of its outstanding stock were surrendered in exchange for common stock of the taxpayer. As a result of such exchanges, an aggregate of 79,731 shares of taxpayer's common stock (out of a total of 200,000 shares, par value 10 cents per share) were issued to Shubert's creditors and stockholders. (Pet. 42.)

The basis in the hands of Shubert of the assets purchased by taxpayer at the sale on April 7, 1933, was upwards of $4,000,000. (Pet. 32.)

This litigation was instituted to recover excess profits taxes paid for the fiscal year ended June 30, 1943. In the consolidated income and excess profits tax return for that year filed by taxpayer and its

subsidiaries, the excess profits credit was computed under the invested capital method provided by Section 714, *et seq.*, of the Internal Revenue Code of 1939. And in this computation, taxpayer treated the amount it paid for the Shubert assets ($400,000) as its invested capital. In seeking refund, taxpayer now contends that it was entitled to adopt the basis of the assets in the hands of Shubert ($4,000,000) in determining its invested capital. (Pet. 30-32.)

ARGUMENT

1. The controlling question is whether taxpayer acquired the assets of an insolvent corporation (Shubert) in a tax-free reorganization under Section 112 (b)(4) and (i) of the Revenue Act of 1932, *supra*, pp. 2-3.[2] The courts below answered this question in

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[2] If so, taxpayer is entitled to adopt the basis of the assets in the hands of Shubert ($4,000,000), rather than the amount it paid at auction for the assets ($400,000), in computing its excess profits credit for the tax year in question. In the computation of equity invested capital for the purposes of the excess profits credit, Section 718(a)(2) of the 1939 Code, *supra*, pp. 4-5, entitled the taxpayer to include "Property * * * paid in * * * for stock, * * * in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange." Section 113(a) of the same Code governs the basis (unadjusted) for determining gain or loss, and subsection (a)(12), *supra*, p. 4, provides that the unadjusted basis of property acquired between 1913 and 1934, if prescribed by Section 113(a)(6), (7), or (9) of the Revenue Act of 1932, shall be as therein prescribed. Section 113(a)(7) of the 1932 Act, *supra*, p. 3, provides for substitution of basis if there is a tax-free reorganization, and if other conditions are met. Section 112(i) of the 1932 Act, *supra*, pp. 2-3, defines the term "reorganization" as including, among other things, the acquisition by one corporation of substantially all of the properties of another. Since a re-

the negative primarily on the ground that, although there was literal compliance with the statutory requirements, there was a lack of the continuity of proprietary interest required for a valid reorganization under decisions of this Court, notably *Helvering* v. *Limestone Co.*, 315 U.S. 179, and *Palm Springs Corp.* v. *Commissioner*, 315 U.S. 185. Far from being in conflict with those and related decisions, as taxpayer asserts (Pet. 12-16), the decision below is in complete accord with them. In any event, the decision below raises no question of general importance, and its significance is limited to the particular circumstances here presented.

The continuity of interest requirement may be briefly formulated as follows: Where one corporation transfers its assets to another, the transaction does not constitute a valid reorganization unless the proprietors of the transferor retain a substantial proprietary stake in the transferee, and unless the retained interests represent a substantial part of the value of the assets transferred. *LeTulle* v. *Scofield*, 308 U.S. 415; *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378; *Pinellas Ice Co.* v. *Commissioner*, 287 U.S. 462. If the transferor is solvent its proprietors are, of course, its stockholders, and hence they must receive a substantial proprietary stake in the new cor-

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organization is not automatically tax-free, but must qualify as such under one of the provisions of Section 112(b), the final provision relevant here is Section 112(b)(4) of the 1932 Act, *supra*, p. 2, which provides that no gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

poration. However, if the transferor is insolvent the problem of identifying its proprietors as of the time of transfer is more difficult. *Helvering* v. *Limestone Co.*, *supra*, involved a bankruptcy sale of corporate assets to a committee of the creditors who, in turn, transferred the assets to a new corporation in exchange for its stock, pursuant to a plan of reorganization. This Court held that the continuity of interest test was satisfied because the creditors of the old corporation were not only the proprietors of the new, but had become the proprietors of the old, prior to the bankruptcy sale. More particularly, it was held that the equity ownership of an insolvent corporation shifts from its stockholders to its creditors when the creditors take steps to enforce their demands against the corporation. And in the case before it, the Court ruled that the shift occurred upon the institution of bankruptcy proceedings.

It is abundantly clear from the opinion in *Limestone Co.*, *supra*, and in the related cases of *Palm Springs Corp.* v. *Commissioner*, *supra*, and *Bondholders Committee* v. *Commissioner*, 315 U.S. 189, that the equity ownership of a corporation does not shift to its creditors, whether secured or unsecured, solely by virtue of the insolvency of the corporation. The shift occurs only when the creditors establish effective command over the assets by taking the steps necessary to oust the stockholders from control. Whether such effective command has been secured by the creditors prior to the transfer of assets is a question which depends upon the peculiar circumstances of each case. In *Limestone Co.*, the Court dated the shift of equity ownership from the initiation of bank-

ruptcy proceedings. In *Palm Springs Corp.* and *Bondholders Committee*, the shift was deemed to occur when bondholders initiated foreclosure sales. Under other circumstances, other procedures might be deemed sufficient. But, at all events, the creditors must, by overt action, take the helm of the old corporation and effectively control the disposition of its assets.

In the case at bar, th courts below have concluded that the taxpayer, albeit the stockholder-proprietor of the new corporation, was not the proprietor of the old at the time of the auction sale merely by reason of the acquisition of receivers' certificates. This determination was essentially factual. Full cognizance was taken of the controlling criteria (Pet. 44-48), and we submit that they were correctly applied. Furthermore, in view of the detailed and closely-reasoned opinion of the District Court, adopted by the Court of Appeals, we believe it will suffice here to advert to the following principal reasons why the taxpayer errs in contending that it became the proprietor of the old corporation prior to the auction sale: (1) As a holder of receivership certificates taxpayer was not even a creditor of the old corporation (Shubert) but simply a creditor of the receivers with carefully delimited rights against the receivership assets; (2) The receivers' certificates were not even due, much less in default, at the time of the auction sale--and, in fact, they were satisfied in full by their application to the purchase price; (3) It follows that taxpayer was never in a position to take the necessary steps, nor did it purport to take such steps, to secure effective command over the assets of Shubert

prior to the auction sale. Without more, it is clear that the conclusion of the courts below was not only in accord with, but was required by, the relevant decisions of this Court.

2. Taxpayer also asserts a conflict between the ruling of the courts below and the decision in *Minneapolis, N. & S. Ry.* v. *Kelm*, 117 F. Supp. 325 (Minn.), affirmed, 225 F. 2d 909 (C.A. 8th). That case is plainly distinguishable. There an insolvent railroad went into receivership, and the holders of collateral trust notes commenced foreclosure proceedings to liquidate the railroad properties, thus assuming effective command of the corporation's assets. Thereafter, and prior to the foreclosure sale, the holders of the notes assigned all of their rights to other parties for valuable consideration, and the assignees purchased the assets at the sale and transferred them to a new corporation in exchange for stock. On these facts, it was held that the requisite continuity of interest was present, the assignees of the notes being regarded as standing in the place of the assignors—who had theretofore acquired the equity ownership of the old corporation. In the case at bar, taxpayer did not succeed, by assignment or otherwise, to the rights of the creditors of the old corporation; it had only certain prescribed rights as a creditor of the receivers. Furthermore, its claims as such creditor were, in effect, paid in full when due.

3. Taxpayer also asserts a conflict with the decision in *Northern Pacific Ry.* v. *Boyd*, 228 U.S. 482, which established the full priorities rule. So far as that rule is relevant, it has been drawn into the

continuity of interest test by the decision in *Limestone Co.*, which cites it (p. 183) as giving creditors of an insolvent corporation the right to exclude the stockholders from the reorganization plan. But *Limestone Co.* also holds that this right must be affirmatively exercised by the creditors in order to shift the proprietary interest for the purpose of the continuity test. Since taxpayer was not a creditor of the old corporation to begin with, and never took (nor could take) the necessary steps to assume effective command of the assets, *Northern Pacific Ry.* is inapplicable.[3]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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MARCH, 1958.

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[3] The fact that the old creditors and stockholders of Shubert later received some of the common stock of the taxpayer is irrelevant. As the District Court pointed out (Pet. 53-55), the record is clear that they received the stock as a gratuity, and not (save by way of formality) in exchange for their claims.

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